

**ALASKA STATE LEGISLATURE
LEGISLATIVE BUDGET AND AUDIT COMMITTEE**

Anchorage, Alaska

June 15, 2006

9:08 a.m.

MEMBERS PRESENT

Senator Gene Therriault, Chair
Senator Lyman Hoffman
Senator Gary Wilken (Alternate)

Representative Samuels, Vice Chair
Representative Beth Kerttula
Representative Kevin Meyer (Alternate)
Representative Reggie Joule (Alternate)

MEMBERS ABSENT

Senator Ben Stevens
Senator Burt Stedman
Senator Lyda Green

Representative Mike Chenault
Representative Mike Hawker
Representative Pete Kott

OTHER LEGISLATORS PRESENT

Senator Gretchen Guess
Senator Hollis French
Senator Gary Stevens
Senator Kim Elton
Senator Fred Dyson

Representative Bill Stoltze
Representative Les Gara
Representative Berta Gardner
Representative Jay Ramras
Representative David Guttenberg (via teleconference)

COMMITTEE CALENDAR

ECON ONE PRESENTATION TO THE LEGISLATURE
EXECUTIVE SESSION
RELEASE OF AUDITS
AUDIT REQUESTS

OTHER COMMITTEE BUSINESS
PRESENTATION BY DANIEL JOHNSTON & CO.
ROUNDTABLE DISCUSSION

PREVIOUS COMMITTEE ACTION

No previous action to record

WITNESS REGISTER

BARRY PULLIAM, Senior Economist
Econ One Research, Inc.
Los Angeles, California

POSITION STATEMENT: Presented information on the fiscal interest findings.

JEFFREY LEITZINGER, Ph.D., Senior Economist & President
Econ One Research Inc.
Los Angeles, California

POSITION STATEMENT: Presented information on the impact of the fiscal bargain provided in the fiscal interest findings.

ANTHONY FINIZZA, Ph.D., Consultant
Econ One Research, Inc.
Los Angeles, California

POSITION STATEMENT: Presented comments on liquefied natural gas (LNG) project in relation to the fiscal interest findings.

SENATOR FRED DYSON
Alaska State Legislature
Juneau, Alaska

POSITION STATEMENT: Requested an audit as to the printed policy of the state [regarding reporting of sexual abuse] and the conformity of the agencies to it.

PAT DAVIDSON, Legislative Auditor
Division of Legislative Audit
Alaska State Legislature
Juneau, Alaska

POSITION STATEMENT: Provided information on the audit requested by Senator Dyson.

DANIEL JOHNSTON, Owner
Daniel Johnston & Co., Inc.
Hancock, New Hampshire

POSITION STATEMENT: Presented a preliminary review and discussion of the proposed gas pipeline contract and the fiscal interest findings.

PEDRO VAN MEURS, Ph.D., President
Van Meurs & Associates Limited
Nassau, Bahamas

POSITION STATEMENT: Provided comments.

MARIANNE KAH, Chief Economist
ConocoPhillips Alaska, Inc.
Anchorage, Alaska

POSITION STATEMENT: Provided comments regarding ConocoPhillips Alaska, Inc. and the fiscal interest findings.

DAVID VAN TUYL, Commercial Manager
Alaska Gas Group
BP Exploration (Alaska) Inc.
Anchorage, Alaska

POSITION STATEMENT: Provided comments regarding BP Exploration (Alaska) Inc. and the fiscal interest findings.

ROGER MARKS, Economist
Department of Revenue
Juneau, Alaska

POSITION STATEMENT: Provided comments regarding the fiscal interest findings.

KEN GRIFFIN, Acting Deputy Commissioner
Anchorage Office
Office of the Commissioner
Department of Natural Resources (DNR)
Anchorage, Alaska

POSITION STATEMENT: Provided comments regarding the fiscal interest findings.

DAN DICKINSON, CPA
Consultant to the Governor
Office of the Governor
Juneau, Alaska

POSITION STATEMENT: Provided comments and answered questions regarding the fiscal interest findings.

S.A. (BILL) MCMAHON JR., Commercial Manager
Alaska Gas Development
ExxonMobil Production Company
Houston, TX

POSITION STATEMENT: Provided comments regarding ExxonMobil Production Company and the fiscal interest findings.

ACTION NARRATIVE

CHAIR GENE THERRIAULT called the Legislative Budget and Audit Committee meeting to order at [9:08:40 AM](#). Representatives Samuels, Kerttula, and Joule (alternate), and Senators Hoffman, Wilken (alternate), and Therriault were present at the call to order. Representative Meyer (alternate) and Senator Ben Stevens arrived as the meeting was in progress. Also present were Representatives Stoltze, Gara, Gardner and Guttenberg (via teleconference), and Senators Guess, French, Gary Stevens, Elton, and Dyson.

Impact of Fiscal Terms

[9:09:38 AM](#)

BARRY PULLIAM, Senior Economist, Econ One Research, Inc., informed the committee that there would be three presentations. The first presentation, he said, would offer additional details regarding the information given to the committee the previous day, in an attempt to quantify the affects of the fiscal interest findings. He stated that the second presentation, given by Dr. Jeffrey Leitzinger, would focus on the economical aspects of the contract. Finally, he said, Dr. Anthony Finizza would join him to discuss the economics of "LNG delivery" versus "pipeline delivery."

[9:10:26 AM](#)

MR. PULLIAM, referring to page two of the handout titled "Comments to Legislature on Gas Contract and Fiscal Interest Findings, June 15, 2006, Impact of Fiscal Terms," explained the key differences between the proposed contract versus the current fiscal system.

[9:12:11 AM](#)

MR. PULLIAM, in regard to ownership of the pipeline, explained that the state would take a 20 percent interest in the pipeline. The state, he said, would receive its gas in-kind, and would make a firm transportation (FT) commitment to ship, in conjunction with the capacity agreements included in the contract. In addition, he said, the state would receive tariff revenue for its investment, which the fiscal interest findings

show to be between 12-14 percent. He stated that the only "real concern" regarding capacity issues would be if the gas was not available.

[9:15:02 AM](#)

MR. PULLIAM, in response to a question, explained that areas of the pipeline owned by the United States would have an estimated tariff of 14 percent, while portions owned by Canada would have an estimated return of 12 percent. In response to an additional question, he stated that Mr. Harper was involved in evaluation of the Lukens Energy Group study on risks regarding capacity.

[9:17:08 AM](#)

MR. PULLIAM, moving on to slide 4, entitled "Evaluation of Impact of State Ownership of Pipeline (Base \$6.00 Gas Case), explained the impacts on the state versus impacts on the producers. He said:

One of the things I want to point out on this chart [is that] - you've heard - in the fiscal interest findings and ... folks who have presented it - talk about [how the state] taking ownership of the pipe and taking FT [will have an] impact on the IRR. This shows that ... if you analyze it ... on an integrated basis, both upstream and downstream together, [this] would move the IRR about 2.5 percent, because the state is taking that initial investment. So ... as we go through it, you'll see in the end, this is the single ... biggest effect on the producer economics.

[9:21:33 AM](#)

CHAIR THERRIault asked if the state taking its investment on the low return portion of the global project would increase the rate of return.

MR. PULLIAM replied that this is correct.

[9:22:24 AM](#)

MR. PULLIAM directed attention to the next slide, titled "Evaluation of Impact of Severance Tax Treatment (Base \$6.00 Gas Case Relative to PPT System). The state would, he said, take severance taxes at 7.5 percent, which differs from the Petroleum Production Profits Tax (PPT). In terms of 2005 revenues, he

said, the difference is around \$11 billion, and around \$3 billion in net present value (NPV). The increased revenue for the state results in a decrease in revenue for the producers. In response to a question, he explained that the PPT severance tax rates would be higher than those in the proposed contract. Therefore, under the contract, the revenue for the producers would increase. He stated that the PPT had a 20 percent severance tax rate, along with a gross revenue exclusion of .67 percent. This, he said, takes the rate on wellhead value down to 13.3 percent.

[9:25:16 AM](#)

MR. PULLIAM, moving on to slide 6, titled "Evaluation of Impact of Severance Tax Treatment (Base \$6.00 Gas Case Relative to ELF System Rates Only), explained that the economic limit factor (ELF) system uses a 7.25 percent severance tax rate, in comparison to the 7.5 percent rate of the proposed contract. Continuing on to slide 7, titled "Evaluation of Impact of Severance Tax Treatment (Base \$6.00 Gas Case Relative to ELF System Rates and Contract Deducts/Credits), he explained that the impact of the deductions and credits allowed under the contract.

[9:26:29 AM](#)

MR. PULLIAM, referring to slide 8, titled "Impact of GTP/Feeder Credits," stated that the contract also includes a 35 percent credit for gas treatment plant (GTP) and feeder line, while there is no credit under the current system. This is, he said, in addition to the current Federal tax credit of 15 percent of GTP construction costs. Moving on to slide 9, he pointed out that the impact on the state is estimated at about \$896 million. In regard to the effect this credit would have on producers, he said, the NPV is increased by 1.7 percent, and the internal rate of return (IRR) by 0.8 percent. He noted that the aforementioned credit would not be applied to pipeline owned by the state.

[9:28:48 AM](#)

MR. PULLIAM, in response to questions from Chair Therriault, explained that the credit does not flow-through, adding that the total amount of credit will be \$896 million. Referring to slide 10, titled "Impact of State Taking Gas In-kind," he explained that taking the gas in-kind would result in an additional marketing cost, which is estimated at 5.5 cents per Mcf. The

State, he said, has also considered the loss of the royalty-in-value (RIV) and royalty-in-kind (RIK) options, along with the loss of royalty associated with the "higher of" provisions included in the royalty leases, which has an estimated value of 2 percent.

[9:31:49 AM](#)

MR. PULLIAM went on to explain slide 11, titled "Evaluation of Impact of State Taking Gas In-Kind." Moving on to Slide 12, he said that according to the settlement agreement between the state and producers, the state pays upstream cost allowance (UCA) on royalty gas at Prudhoe Bay. At this time, the aforementioned requirement is limited to Prudhoe Bay; however, under the contract, the state would pay UCA on all royalty and tax gas. In addition, he said, the inflation rate is based on the consumer price index (CPI), rather than the petroleum price index (PPI).

[9:33:02 AM](#)

MR. PULLIAM brought attention to slide 13, titled "Evaluation of Impact of UCA (Base \$6.00 Gas Case), and pointed out a \$1.4 billion difference in revenue for the state, along with a \$418 million difference in NPV. There is a positive impact on the producers, ultimately increasing the NPV by 0.9 percent, in addition to a 0.1 percent increase in IRR. Moving on to slide 14, titled "Impact of Gas Treatment Costs," he explained that under the current system, the state pays for treatment costs on Prudhoe Bay royalties, along with all severance taxes, under the contract, this would extend to all royalty and tax gas. Turning to slide 15, he explained the impact of the additional gas treatment costs.

[9:36:17 AM](#)

MR. PULLIAM, in regard to property taxes, explained that currently, the tax is 2 percent of facility value. Under the contract, he said, this will change to a per million cubic feet (Mcf) or per million British thermal units (MMBtu) payment formula, escalating with CPI. Referring to slide 17, he explained the impact of the aforementioned property tax changes. In regard to the CO2 disposal costs, he stated that this was not included in the analysis. He noted that slide 18 is a summary of the previous slides. He noted that the previous charts were created using a "base case of \$6.00 gas." Slide 19, he said, uses a low price scenario of \$4.00, while slide 20 uses a high

\$8.00 scenario. He stated that slide 21 uses a \$5.50 gas case scenario, which is used in the fiscal interest findings.

[9:41:47 AM](#)

CHAIR THERRIAULT, referring to slide 18, asked for confirmation that the state would receive a \$400 million benefit from owning 20 percent of the pipeline.

MR. PULLIAM replied that this is correct adding that this is based on pipeline income, in addition to no tax payments on the state-owned portions.

[9:42:46 AM](#)

SENATOR WILKEN inquired as to why the profitability index was not included in slide 18.

MR. PULLIAM replied that this was due to lack of space; however, this information is available.

[9:43:28 AM](#)

SENATOR WILKEN said:

As a laymen, I'm looking at this, and ... what strikes me-other than the ownership issue-is, I look at those numbers and I ... say "so what?" You can fiddle with this all you want, and the profitability index moves just tenths of a percent. The IRR moves tenths, and the rest of it ... just 1.5-2 percent. Is that the ... right attitude that I should have?

[9:44:08 AM](#)

MR. PULLIAM replied:

I think that's ... a key point. That's certainly the biggest issue and the biggest mover. I think that was, indeed, the ... thing that was cited in the fiscal interest findings as ... the single biggest impact on IRR, if you're this on an integrated investment basis. Now, there is an impact, also, in terms of NPV. If you're looking at the ... tax rates in the contract versus those that are proposed in PPT. That's also a ... large difference. [However], it is ... smaller than the pipeline ownership.

[9:46:15 AM](#)

SENATOR ELTON inquired as to whether difference in how the state takes the royalty and taxes would result in a \$2 million difference.

[9:46:59 AM](#)

MR. PULLIAM replied that this is correct, noting that the impact on the investment metrics for the producers, are "not nearly as big" as the impact state ownership would have.

[9:47:33 AM](#)

SENATOR ELTON asked if the possibility of project construction past Alberta, Canada had been considered.

MR. PULLIAM replied that it is unlikely that the project construction would go past Alberta, with additional use and/or expansion of existing facilities.

[9:48:25 AM](#)

CHAIR THERRIAULT asked if the benefit of ownership applies to any owner.

MR. PULLIAM replied yes. This, he explained, would be "taking that portion of the investment off."

CHAIR THERRIAULT offered his understanding that this is because the pipeline is the regulating utility and is part of a global package, which then "drags down the return."

MR. PULLIAM agreed that this is correct.

[9:48:56 AM](#)

MR. PULLIAM, in response to a question, explained that current law and the proposed contract overlap in some areas; therefore the amounts cannot simply be added up to the total.

REPRESENTATIVE GARA requested a cumulative difference between the current law and the contract, in addition to the effect this would have on the profitability index and the internal rate of return.

SENATOR WILKEN, referring back to a previous handout, said:

If we take the profitability index out of here, that dances around 3.3-3.47, and put it on here, then it's on this axis, right there. So, I would say, that this project, that we see today, is the fifth most profitable in all of these sanctioned projects. Instead of ... this chart says that it's the 14th. So, am I ... correct? And we don't know if these other four [are] mega projects, \$10 billion projects, or not. But, we know that all of these are big projects. Am I making the conclusion, jumping from here back to here, to show that this is perhaps the fifth to the eight most profitable project?

MR. PULLIAM replied that the aforementioned charts have a different price assumption, therefore, this may not be correct, and may require further analysis.

[9:52:30 AM](#)

REPRESENTATIVE GARDNER said:

I just want to make sure I understand. Today's Anchorage Daily News ... has a big headline [stating] that the project is "highly profitable, likely to happen." What I'm understanding here is that the justification for all the provisions regarding changes to the tax rate, royalty in-kind, credit from the GTP, and all of that, is to change the IRR, and thus make the project stack up higher and be more attractive to the producers. But, what you're saying is that even though there are all these significant cost increases to the state, it doesn't dramatically change the IRR.

MR. PULLIAM replied as follows:

If you look at it ... as it ranks, relative to the other projects ... it doesn't change it in that ordering of things. ... The single biggest effect is the state taking ownership.

[9:53:45 AM](#)

CHAIR THERRIault restated that the impacts listed on the summary sheet cannot be added up to a legitimate number.

[9:53:58 AM](#)

MR. PULLIAM agreed and added that while some items are additive, others have interactive effects.

[9:54:27 AM](#)

SENATOR HOFFMAN, referring to slide 18, asked if it would be possible to have the same information on SB 2001.

MR. PULLIAM replied yes.

[9:55:29 AM](#)

The committee took an at-ease from [9:55:50 AM](#) to [10:15:25 AM](#).

Evaluating the Fiscal Bargain

[10:15:27 AM](#)

CHAIR THERRIAULT, in regard to previous testimony, inquired as to when it is appropriate to utilize IRR as a comparison tool.

[10:16:40 AM](#)

JEFFREY LEITZINGER, Ph.D., Senior Economist & President, Econ One Research Inc., replied:

The starting point [in] our perspective in coming to the problem, is looking at the conclusions that are set forth in the findings. And a principle rationale for the fact that there is a problem with the gas project and a need for some relief, is that it is disadvantaged from an IRR standpoint. [We spent some time yesterday on] one response to that, which is [that] IRR is really not a good performance measure. And whether or not the project stands well, relative to other projects on IRR, should not be an important consideration. [Rather, they should be considered] separate and apart from that, since that is the basis upon which the findings were—as I would read them—put forth regarding this contract. That is, that IRR is the “Achilles heel ” We want to keep coming back to that, on the way we show the results, so that you can see, even on those terms, where is the IRR effect

here? What concessions matter to it? What concessions don't matter? And why do they matter?

10:18:00 AM

REPRESENTATIVE JOULE asked to whom the IRR would be considered the "Achilles heel."

DR. LEITZINGER replied that this would be from the standpoint of the investors.

10:18:19 AM

CHAIR THERRIAULT clarified that this would be in comparison to the rates of return the companies expect to get. He said "We're trying meet that hurdle that they ... expect to get out in the world ... when they invest money exploring and developing the resource."

10:18:51 AM

DR. LEITZINGER stated that he would be discussing the economic evaluation of the fiscal bargain which is provided in the fiscal interest findings. It is very important, he said, to describe the framework which is being used for the evaluation, adding that there may be many different perspectives involved. He said:

So, let me describe my perspective, as I have come to looking at this bargain. It seems to me, if the starting point ... in the findings is that the project is disadvantaged from some perspective, and it is in the states interest then, to grant certain concessions relative to the existing fiscal regime, it would follow that the benefit to those concessions should be that they would ... in some fashion ... alleviate the disadvantages that the project faces. And would cause it to go forward more quickly. Or, would cause it, in some other fashion, at the end of the day, to generate a higher net present value for the state. And that's the trade-off that I have thought about in evaluating the bargain. In particular here, as I've shown in slide two, one should start with the concession dollars, which Mr. Pulliam has quantified as between roughly \$3 and \$5 billion, depending upon whether you are comparing it to the ELF system or to something like the PPT proposals that are currently under

discussion. If those concession dollars are less than the increased net present value of the states dollars ... to be received from the project, it would seem to me that [this would promote] the states fiscal interest. If, on the other hand, the concession dollars are less-than the increase in the expected net present value of the project ... it seems to me that granting those concessions harms the states fiscal interest. So, it is really, in my way of thinking and evaluating the fiscal bargain, what I am looking to, is the size of the concession dollars on the one hand, and the change in the expected net present value of the project from the states standpoint on the other.

DR. LEITZINGER, referring to slide 2 of the handout entitled "Comments to Legislature on Gas Contract and Fiscal Interest Findings, June 15, 2006, Evaluating the Fiscal Bargain," stated that the concessions will either speed up the time until the project would reach it's sanctioned decision, thereby speeding up the project commencement, or change the chances of project approval.

DR. LEITZINGER went on to point out the importance of considering the type of timing advantage which would make the concession dollars a "good bargain" for the state. Referring to slide 3, titled "Relating Cost of Concessions to Project Timing (\$6.00 Base Gas Case), he explained that under the proposed contract, the project is anticipated to begin in 2015. The project would also have, in this case, an NPV of \$14.7 billion. He then explained the differences in NPV in relation to ELF and PPT, pointing out that the difference between these numbers results in the \$3-\$5 billion previously mentioned in regard to concession value. With an ELF based program, he said, the project start date can be delayed five years before reaching the NPV of the proposed contract. The PPT based system, however, would allow an eight-year delay.

[10:26:20 AM](#)

DR. LEITZINGER reiterated an earlier statement regarding the importance of advancing the project startup date. He does not, he said, see evidence that it would be worthwhile to commence the project "in today's environment." Nor does he foresee the concessions having a significant impact on the project start date. He said:

However, ... assuming that the contract concessions ... would provide some impetus to start the project sooner - [let's]take that as a starting point - I then ask ... "when would the project proceed anyway ... in the absence of the ... concessions that are proposed here?" The first thing I note is that we don't have ... any evidence in the findings, on that subject. ... I don't think it's fair to presume that it would never happen. ... We are talking ... about one of the largest reserves available in the world today, with ... the largest net present values. I think the fairest conclusion [is that] it's going to happen sometime.

[10:29:40 AM](#)

DR. LEITZINGER, referring to slide 5, titled "Ranking of Alaska Gasline by Size Class," commented that the contract would not cause a considerable difference in ranking, and opined that this would not result in a "big difference in project scheduling." This type of comparison, he said, would suggest that "the project ... sits in line ... somewhere in ... the last 20 projects." He noted that the other projects in the comparison have reached project sanction. He said:

So, from the standpoint of a decision to go forward, I don't see the gas project here in Alaska as standing behind these projects at all. The question is "what projects is Alaska standing behind?" I don't' ... see ... any evidence about that in the findings. I ... don't see where, among the group of projects that have yet to be sanctioned and have yet to proceed, where Alaska would fall, or any evidence that these changes ... associated with the concessions would change it's position in that line up.

[10:32:22 AM](#)

CHAIR THERRIAULT inquired as to whether the evaluation had been based on an economic comparison, adding that there may be additional motivation driving the decision.

DR. LEITZINGER replied yes, and said:

Because the concessions at issue don't change any of those other things ... and ... the case ... that was presented ... for why these concessions are going to

be beneficial, was not based on ... the reversionary language, or other circumstances that effect worldwide development. It was ... a case about the economic measures. I think it's fair then, to [ask] the question ... how important is the change that these concessions will make -- and why is there reason to believe ... since the timing of this project is really a key issue - that it will change the timing at all?

10:34:02 AM

DR. LEITZINGER, turning to slide 6, titled "Economic Evaluation of the Bargain Presented by the Contract," began by discussing the three concessions featured in the Fiscal Interest Findings. These concessions are: Fiscal Certainty on Oil; Fiscal Certainty on Gas; State Pipeline Investment. These concessions, he said, are considered to be "significant and important, for purposes of the project." In regard to fiscal certainty on oil, he offered his understanding that this is necessary in order to ensure that the state does not raise oil tax as a result of project sanction; however, there is no reason to believe that the presence or absence of a gas project would have an impact on, or predispose the state to raise oil taxes.

DR. LEITZINGER said:

There is another argument that's offered in favor of the [fiscal certainty on oil]. It starts, I think, with the presumption that there is fiscal certainty on the gas side, ... so that the gas tax is ... locked at a certain level over time. And then the argument is: "If the state were to come back and raise oil taxes, it would create a differential tax structure between tax and oil." ... That would create problems between the ... state and the producers, about whether or not the producers were shifting resources from one to the other to avoid taxes, whether or not they were following the right development path. I see no indication or evidence to suggest that the prospect for those kinds of issues ... somehow creates an obstacle to the development of Alaska gas. So, I find it hard to see, in ... the rest of the discussion, that ... if ... it's worthwhile to provide fiscal certainty on gas taxes, it is also necessary to provide fiscal certainty on oil taxes, in order to make this project viable. I don't see that connection.

The findings recognize that ... at some point, after the known gas reserves are ... produced and marketed, it would be necessary to find and develop more reserves for the pipeline, to ... sustain the economics on an overall basis. That, I think, is expected to occur ... some 20 years after the project commences. One of the points that's raised on fiscal certainty for oil is: ... If, in that interim period before that 20 year mark is reached, the state were to raise oil taxes, ... that would potentially discourage oil development. And that ... would have the effect of limiting the supplies of associated gas that would otherwise come with the oil, that would be needed for the pipeline - and that that would have a detrimental effect on the pipeline economics today.

... My comment on that is ... it seems to ... suppose a high degree of economic irrationality on the states part. 20 years after this project commences, the state is - at least based on what we know today - going to be at a time at which the reserves from Prudhoe Bay ... are largely depleted, the production levels will be lower. The state will have a tremendous incentive for the producers to find - not just new gas, but new oil. And the suggestion that, in that environment that the state will raise oil taxes to the point that it would discourage that new oil development, would seem to me to fly squarely against its own interest. So, the prospect that this kind of situation would occur, seems, to me, to be remote, and doesn't seem to be a valid reason to ... bind the state to oil fiscal certainty today.

The last point ... that's made in the fiscal findings [regarding] oil tax certainty, is: If the state raises oil taxes, it might, in it's own right, discourage the development of smaller oil reserves. That argument, ... while there may or may not be validity to it, is a matter ... for the people in the state who make decisions about tax levels on oil. It doesn't seem to me [that it has a] place in thinking about whether this gas project is viable, ... whether ... it will occur, and when.

[10:40:54 AM](#)

DR. LEITZINGER went on to discuss fiscal certainty on gas. He stated that in the findings, fiscal certainty is identified as being a key and essential component in project advancement. The "crux" of the argument, he said, is that Alaska's natural gas reserves are "economically disadvantaged" in relation to projects around the world. He noted that this problem is based on economic metrics rather than fiscal stability. The findings do not show that the gas is "stranded" due to a lack of fiscal stability, or that this would "turn the economics of the project upside-down." He said:

What the findings do say, is that (... [keeping in mind that this is a] significant investment, ... [and] noting that there are risks ... associated with the project ... having to do with low prices and cost over-run), it is important to balance those risks with the prospect that if cost overruns don't occur and prices are favorable, there will be an upside benefit to the project. As an economic matter, I wholeheartedly agree. The ... findings then go on to say: The fiscal certainty on gas taxes is necessary to achieve that balance. The prospect being if, in the upside, the state were to greatly increase taxes on gas, it might take away the upside benefits, upset the balance between upside balance and downside risks, and discourage the project. I think it's important in evaluating that argument ... to go back to where it starts. The argument is about where Alaska stands relative to projects in the rest of the world. And I would ask the question: Whether or not the prospect for fiscal uncertainty, and the effects that ... might have on project upside, is any worse or any more of a drag on the project in Alaska as it is for projects in the rest of the world?

[10:44:04 AM](#)

DR. LEITZINGER, referring to slide 7, showing locations of other projects, noted the concentration of projects in Equatorial Africa, South America, Central Asia, and the Middle East. He questioned the reasoning behind the belief that these areas have more fiscal certainty. He said "I think that the question carries an obvious answer - no."

[10:44:58 AM](#)

REPRESENTATIVE SAMUELS inquired as to how projects of different magnitudes can be compared.

[10:46:17 AM](#)

DR. LEITZINGER replied that this was taken into consideration and the projects were "pared down" to those with investments "north of \$3.5 billion." However, while the number of projects shrinks, the "picture doesn't change." He opined that many of the aforementioned projects are going forward in countries that have a "different and lesser" level of fiscal and political certainty than exists in Alaska. He said:

So, I'm not sure I agree with ... your observation that as you increase the project investment - there is at least the potential - that the downside risk becomes more significant. ... Even if you just focus on larger projects, I think the basic points of comparison remain the same.

[10:48:25 AM](#)

REPRESENTATIVE SAMUELS asked if Econ One had done research regarding what might happen if the project "goes poorly," and the effect this might have on the various companies, specifically ConocoPhillips Alaska, Inc. (Conoco).

DR. LEITZINGER replied that he has not done a "careful financial analysis" of Conoco. Therefore, he said, he would be unable to give an answer.

[10:49:31 AM](#)

DR. LEITZINGER quoted from a The New York Times article titled "As profits surge, oil giants find hurtles abroad" as follows:

In Bolivia and Russia, governments have taken outright control of oil and gas fields; in Venezuela and Britain, they have increased taxes; and in Nigeria and Kazakhstan, they have given highly preferential treatment to state companies.

Last week, Bolivia said it would seek 82 percent of the sales from the biggest fields, up from less than 18 percent.

In Venezuela, the government recently asserted its hold on 32 small oil fields developed by foreign companies and increased taxes to 83 percent from 56.6 percent.

DR. LEITZINGER said:

I look at ... those kinds of events in the rest of the world, and ... look at Alaska and say "there is a marked difference" both in political and fiscal certainty. ... I don't see that Alaska is disadvantaged in that regard. ... Understanding that Alaska is not, itself, disadvantaged from the standpoint of fiscal certainty, ... one might make the point that ... the project for other reasons, [such as transportation costs], faces some challenges. Providing ... a high level of gas tax certainty ... is enough to off-set the other challenges, and ... by doing so, one would [provide the impetus to move forward with an otherwise uneconomical project.] [However,] that argument ... hasn't been made in the findings. I don't see any evidence or basis upon which one could conclude that the value of fiscal certainty that's being offered in the contract with respect to gas taxes, is somehow ... sufficient to overcome the other disadvantages that are identified in the findings.

[10:52:34 AM](#)

DR. LEITZINGER went on to discuss state pipeline investment. He said:

According to the findings, [the state investment in the pipeline] is the principal source ... for improvement in the projects worldwide attractiveness. [This appears] with respect to the projects internal rate of return (IRR). It moves the calculated rate of return for the project from approximately 24.5 percent [up to] 27 percent. ... I would note that the reason for the change is ... that by having the state assume a 20 percent ownership interest in the pipeline (20 percent ... of the entire pipeline cost, which is included in the IRR calculation ...) 20 percent of that cost is shifted to the state and away from the producers. So, by taking 20 percent of an \$18 billion transportation cost, that neither the state nor the

producers have to put up ... in order to commence the project, ... the producers IRR [is increased] by about 2 points. I ... really question, for the reasons that I mentioned yesterday, whether that is a real and important financial effect, in as much as ... neither of those entities are in a position where they need to make those outlays in order to have the project commence.

One of the things that I would note, in that regard, [is] the findings [show that] ... ownership is attractive to the state. The findings show that by shifting 20 percent to the state, it would enjoy the investment benefit. The findings [also] make the point that [if] the pipeline is sufficiently attractive, ... the producers would not be willing to let somebody else build the pipeline, short of litigation. Well, I would ask: If the pipeline is attractive to the state, for the state to own, and so attractive that the producers wouldn't let another company build it, how can it be that shifting 20 percent of the ownership of the pipeline away from the producers makes the project economics more attractive? I think those observations are fundamentally in conflict with each other. The answer, in my view, is that the calculations of internal rate of return, which [in this case] treats all of the pipeline costs as a front-end investment from the standpoint of the producers, ... is misguided. It's only from that standpoint that the shift of the investment to the state would appear to improve project economics.

CHAIR THERRIAULT said:

If, in fact, the overall "pie" here, the pipeline as a regulated utility is the low producing component. Meaning, it would make sense that sharing that low end with somebody else would improve your overall economics because now you're left with ... more of the upside.

[10:57:44 AM](#)

DR. LEITZINGER replied that if, on a return basis, the low-end of the package is attractive, and moving a portion of the investment component away from the producers should not result in a more attractive project. He said "If you take 20 percent

of [an attractive proposition] and move it out of the project, that can't ... logically make the project ... more attractive."

10:59:00 AM

REPRESENTATIVE GARA asked if the state taking ownership in a "less profitable venture" would increase the rate of return for the oil companies, while decreasing the overall revenue. In addition, he asked if the incentive for the oil companies to keep the 20 percent in question would be "making more money, but at a lower profit rate."

DR. LEITZINGER agreed. He stated that pipeline ownership is "an attractive proposition." By holding onto the projects, he said, the producers would make extra return, although the percentage basis would be lower.

REPRESENTATIVE GARA offered his understanding that fiscal certainty is only available in countries that are not western democracies. He asked if this is correct.

DR. LEITZINGER replied that he does not agree with this statement.

11:01:43 AM

DR. LEITZINGER went on to discuss how the concessions would affect the chance of the project moving forward, once project sanction is reached. He said:

This question arises because the contract, as I understand it, is not in agreement that if the state grants concessions, the project will happen. The agreement is that if the state grants concessions, the sponsors will move forward through a 5 year study period to further evaluate the cost of the project, ... do work to get it developed, [and] get the necessary approval. And then [the sponsors] will reach a point in time, some 5 years from now, where they will ... decide whether or not to proceed. So, in effect ... the state is asked ... to provide the concessions, and what the producers are given, then, is an option to decide, 5 years from now, whether, in the face of those concessions, it makes sense to proceed with the project. I want to suggest a way to think about that trade off and whether or not that's the best way to ... frame the bargain.

DR. LEITZINGER, referring to Slide 10, titled "Contract Costs and Benefits," explained the "economic viability spectrum." He stated that by using the ELF system, the project would be considered viable.

[11:06:08 AM](#)

DR. LEITZINGER went on to explain that granting concessions would change the economics of the project, thereby moving back the point at which it would be viable to go forward. This would create a set of conditions under which the producers may decide it would not be worthwhile to proceed. He then explained the "contract benefits." This is a conceptual matter, he said, and can be considered a portion of what the state is "buying" with the concessions.

[11:08:17 AM](#)

DR. LEITZINGER, in response to a question from Senator Elton, agreed that it would take a "particularly adverse" set of conditions to make the project uneconomic.

[11:09:00 AM](#)

CHAIR THERRIAULT inquired as to why the contract benefits move the status quo further toward the [less viable] portion of the scale.

DR. LEITZINGER replied that because the contract concessions "boost the economics," the producers would be more inclined to move forward with the project at a time when, previously, it may have been considered uneconomic. In regard to the concessions involving fiscal price certainty for oil, he pointed out that the state would pay these "no matter what happens." The concessions relating to gas taxes and tax credits would only occur if the project moves forward. He said "If there's no project, there's no gas tax affects."

[11:12:06 AM](#)

DR. LEITZINGER, moving on to slide 13, explained that the state "pays concessions in a whole range of circumstances where, at the end of the day, it wouldn't have mattered." The state would also pay concessions related to fiscal certainty on oil in all outcomes, including those "in which the project wouldn't go forward, even under the contract." Pointing out the portion of

the slide titled "Contract benefits," he stated that this is "the only places where ... the contract really makes a difference in the decision."

[11:16:12 AM](#)

DR. LEITZINGER, referring to Slide 14, titled "Contract Effects Relative to Range of Uncertainty," posed the questions "How does the effect of the contract compare to the range of uncertainty that we see, based on other important economic elements associated with the project?" and "Is the contract going to have a big [or small] effect in terms of changing the economics against that backdrop?" He said "What I take from this comparison is that the impact of the contract against the broader scope of uncertainty is relatively small." He opined, then, the "contract benefits" portion of the previous slide would be "relatively small." He said:

My bottom line ... is: the manner in which the concessions are structured in this proposal doesn't give the state very much ... "bang for it's buck." It is spending the \$3-\$5 billion in concessions, under this proposal, for a relatively small range of cases in which the concessions will have any impact on what happens. So, in summary, Mr. Pulliam described \$3-\$5 billion in concessions associated with the proposed contract. ... My question here has been "for what?" I don't see the evidence showing that the concessions will speed up the project, or will have a material affect at the end of the day-in the broader context of the uncertainty that exists here-on whether or not the project will ultimately proceed, once it's fully studied and some of these uncertainties have been clarified. And I think, as I review the findings ... I don't see the compelling reason to grant the concessions today, especially in as much as it really, in the end, is nothing more than an option. The proposal is to expend them in exchange for an option five years from now, for the producers to decide to proceed. I don't see the value that flows back from that.

[11:19:49 AM](#)

SENATOR WILKEN asked if the [contract benefits] portion of the diagram represent the "Summary of Impacts of Fiscal Terms," presented by the previous speaker.

DR. LEITZINGER answered yes.

[11:21:39 AM](#)

CHAIR THERRIAULT, referring to Slide 14, opined that if the downside risk were shared, this may have increased the [contract benefits.]

DR. LEITZINGER replied yes.

[11:22:06 AM](#)

SENATOR WAGONER, referring to the Alaska Stranded Gas Development Act Amendments, asked what affect these amendments would have.

DR. LEITZINGER commented that it is difficult to quantify what the state would be "giving up" in relation to the concessions involving fiscal certainty. He opined that the amendments "ties the states hands" in a way that is uncommon in world oil and gas markets.

[11:24:50 AM](#)

REPRESENTATIVE GARA asked if the proposed PPT would have a material impact on the economics of the project.

DR. LEITZINGER replied that there is a "certain symmetry" involved. He explained that the research shows that giving tax concessions to a certain amount does not have a large affect on the project economics. If, he said, the taxes are changed "an equal amount in the other direction," the result is similar. In regard to the proposed PPT, he differed to Mr. Pullium.

[11:26:56 AM](#)

LNG) Project

[11:27:23 AM](#)

CHAIR THERRIAULT announced that the next order of business would be a presentation regarding the Liquefied Natural Gas (LNG) Project.

[Long pause without an at-ease.]

[11:30:16 AM](#)

MR. PULLIAM began by offering a brief overview of the presentation. He explained that the presentation would include a comparison between delivering Alaska gas by an LNG project versus a pipeline project. He noted that the Alaska Gasline Port Authority (AGPA) has recently redirected its focus to include a "Y line," which would deliver gas in a way that is similar to a pipeline project. This, he said, would not be discussed in detail.

[11:33:11 AM](#)

ANTHONY FINIZZA, Ph.D., Consultant, Econ One Research, Inc., turned to Slide 3, titled "Typical LNG Value Chain." He explained that this shows the ways in which an LNG project differs from a pipeline project. The process is broken into the following sections: Field Production, Liquefaction, LNG Tankers, and Import Terminal. He then gave a brief description of each section, noting that the liquefaction stage contains several steps, including pre-treatment, natural gas liquids (NGL) removal, liquefaction, storage, and export. He stated that the liquefaction portion of the process is the most "capital intensive." While costs have decreased over the past several years, they appear to be "leveling off." The liquefaction stage typically costs \$250 million, and has a substantial penalty in terms of fuel loss. The next stage, he said, involves tankers, and the cost depends on the distance. On average, he stated, the capital cost is around \$165 million, with losses around .15 percent per day. Once the gas reaches its destination, the regasification stage begins. This stage may have losses of 2.5 percent. The final stage, he said, is pipeline access. The combined cost for all stages is around \$2.50 per mmBtu, presuming that there is not a large cost for pipeline access.

[11:39:47 AM](#)

MR. PULLIAM, referring to Slide 4, titled "Estimated Costs to Access Market from Pipeline Inlet (2016), stressed the importance of looking at the most favorable way [to sell] the product. First, he said, the cost of "getting the product to market" must be considered. He explained that slide 4 shows costs associated with pipeline delivery to AECO, in addition to LNG delivery to the west coast. He explained that when the AGPA was considering an LNG project, the two primary delivery points were Kidamat and southern California. He noted that the AGPA

was also considering a combined "weighting" of the two options. Movement via LNG is ultimately more expensive, due to several factors, including a longer distance and rougher terrain. The pipeline into Valdez would cost 15 percent more, relative to a pipeline to the Canadian border. LNG project costs include: Alaska Tariff, Canada/Lower 48 Tariff, Liquefaction, Charter, Regasification/Distribution, and Losses.

[11:46:31 AM](#)

MR. PULLIAM moved on to Slide 5, titled "Estimated Netback Values at Pipeline Inlet (Base Case: So Cal = Chicago Less \$0.50), noting that this information was based on the year 2016, in addition, the estimation assumes that the gas price in southern California would be \$0.50 less than Chicago. He pointed out that while the sales value of each project are roughly the same, the costs for the Kitamat and Southern California are higher, resulting in lower netback. In regard to delivering the LNG to the west coast, he stated that shipping the entire volume to the local market risks decreasing the prices. He surmised that this was a factor in the AGPA decision to change its approach.

[11:48:56 AM](#)

MR. PULLIAM then referred to slide 6, titled "Estimated Netback Values at Pipeline Inlet (Low Price Case: So Cal = Chicago Less \$1.00), which shows the change in sales value and netback as a result of a price drop due to large volumes of LNG delivery. Slide 7, he said, estimates the netback values as if the prices in Southern California were equal to those in Chicago. The research shows that it would take an additional \$0.50 premium in Southern California to put its netback on "parody" with the netback estimated for delivery with the pipeline. In conclusion, he said, each proposal has different fiscal terms. [Econ One] has tried to "put them all on a common set of terms," by considering each proposal in terms of existing law. He said:

Our conclusion from all of this is that ... it would appear to us that the netback associated with LNG (particularly if you're trying to put all of your LNG down on the west coast), would not be as favorable as the netback associated with pipeline delivery.

[11:52:47 AM](#)

SENATOR HOFFMAN, referring to Slide 5, asked if the cost would be similar to transport the gas from Fairbanks, Alaska to "points down the Yukon and ... along the transportation route that are water-bound?"

MR. PULLIAM speculated that these prices would potentially be higher, adding that this might not be the most "efficient" way to deliver gas to the aforementioned areas.

[11:54:20 AM](#)

MR. PULLIAM, in response to a question from Chair Therriault, explained that the AGPA Y-line project would be 2/3 highway line and [1/3 Southern California LNG]. He opined that the AGPA has a "more bullish" expectation in regard to the pricing in Southern California than [Econ One]. In addition, he said, one must consider that the Y-line will initially move less product, which may create higher per-unit costs.

[11:56:35 AM](#)

MR. PULLIAM, in response to comments by Chair Therriault, stated that it is difficult to envision decreased efficiency in regard to a Y-line, which creates more options. He opined that the AGPA views increased optionality as having value. In response to an additional question, he remarked that moving less gas would increase the costs per unit, and opined that it would be "less economic."

[11:58:43 AM](#)

SENATOR WILKEN, referring to Slide 4, inquired as to why the "regasification and distribution" for Kitamat is estimated as "almost double" that of Southern California.

MR. PULLIAM replied that this is due to the distance of Kitamat in relation to the "end use" point of the gas. He stated that the regasification component is the same for both; however, the distribution is higher for Kitamat.

[11:59:33 AM](#)

CHAIR THERRIAULT informed the committee that the AGPA would have a response to the presentation which would be distributed as soon as it became available.

[12:00:01 PM](#)

CHAIR THERRIAULT announced that the committee would break for lunch and to take care of additional committee business.

The committee took an at-ease from 12:00PM to 12:01PM.

REGULAR LEGISLATIVE BUDGET AND AUDIT COMMITTEE MEETING:

[12:00:57 PM](#)

CHAIR THERRIAULT announced that the committee would come to order for a regular meeting of the Legislative Budget and Audit Committee. Senators Hoffman, Wilken, and Therriault and Representatives Samuels, Kerttula, and Joule were present at the call to order.

EXECUTIVE SESSION

[12:19:11 PM](#)

REPRESENTATIVE SAMUELS made a motion to move to executive session for the purpose of discussing confidential audit reports under AS 24.20.301. There being no objection, the committee went into executive session at 12:19 p.m.

RELEASE OF AUDITS

[12:48:37 PM](#)

CHAIR THERRIAULT brought the committee back to order at 12:48 p.m. and announced that Senators Hoffman, Wilken, and Therriault and Representatives Samuels, Kerttula, and Joule were present. Senator Ben Stevens (via teleconference) joined the meeting as it was in progress.

[12:49:05 PM](#)

REPRESENTATIVE SAMUELS made a motion that the special audit report on the Departments of Administration and Revenue for the Public Employees' Retirement System (PERS), the Teachers' Retirement System (TRS), and the Alaska State Pension Investment Board (ASPIB) be released to the public for response. There being no objection, it was so ordered.

[12:49:22 PM](#)

REPRESENTATIVE SAMUELS made a motion for the Statewide Single Audit be released to the appropriate agencies for response. There being no objection, it was so ordered.

AUDIT REQUEST

CHAIR THERRIAULT announced that the committee would now take up an audit request from Senator Dyson.

[12:50:29 PM](#)

SENATOR FRED DYSON, Alaska State Legislature, informed the committee that child abuse and child sexual abuse have been an important issue for him during his adult life, especially during his time as a legislator. Although Alaska's reporting laws are good, he opined that the reporting laws aren't being followed. On the national level of the 12- to 14-year-old girls who are sexually active, about 70 percent of them have an adult partner. He then explained that the number of girls who obtain pregnancy services, including services for sexually transmitted diseases (STDs), pregnancy tests, and contraception, can be tracked because all the organizations [receiving federal funds] for those services report the number of young girls seen. He related that in 2003 he reviewed those records in order to determine how many very young girls are coming in for these services. He then sought information from the Alaska State Troopers, the then-named Division of Family and Youth Services, and the Anchorage Police Department regarding the number of reports of sexual abuse for that age group. He related his findings that about 5 percent of the very young girls were reported as abuse victims. The aforementioned lead Senator Dyson to meet with public health nurses to discuss reporting, he said. Most of the public health nurses relayed that they weren't reporting these young girls as potential abuse victims because the nurses' believe that if the word went out that reporting was occurring, then the girls would stop coming. He then related that national statistics show that the older men who are abusing young girls have been shown to have at least five victims.

SENATOR DYSON emphasized that as a state, Alaska has decided that reporting the abuse and [charging] the perpetrator is the best public policy. He credited this administration and Dr. Mandsager, Director, Division of Public Health, in particular, because both believe that the policy has been published, training materials have been made available, and seminars have been conducted for all the mandatory reporters. He then

informed the committee that in 2003 the national organization Life Dynamics performed telephone interviews of hundreds of pregnancy service providers in Texas where one isn't required to notify an individual that the call is being recorded. In these interviews a female presented herself as a 13-year-old girl who wanted to come in for a test and the female related that she had a boyfriend age 21. Nationally, well over 70 percent of the agencies polled told the girl not to mention or lie about her boyfriend's age. In Alaska, the three agencies called instructed the girl not to mention the boyfriend's age.

12:55:41 PM

SENATOR DYSON requested that the Legislative Budget and Audit Committee perform an audit as to the printed policy of the state and the conformity of the agencies to it.

PAT DAVIDSON, Legislative Auditor, Division of Legislative Audit, Alaska State Legislature, related her understanding that the audit request asks the Division of Legislative Audit to review the grantees of the state that provide general pregnancy services and what is required of the staff. The audit request doesn't request the division to calculate how many times it has occurred. She informed the committee that the Epidemiology Section of the Department of Health and Social Services did perform an analysis for information it had from Medicaid services and records. That analysis found that for females' age 10-15 years of age between 1999 and 2003, 317 had billed Medicaid for pregnancy services. Of those, 178 were bills to Medicaid for live births, 114 reported both the father and the mother's ages. Of the 114, 32 were live births and the ages of the mother and the father did indicate statutory rape.

12:58:15 PM

SENATOR DYSON noted his slight disagreement with Ms. Davidson and pointed out that his request specifies that he wants an audit of the agencies in order to determine whether the agencies and their staff are following the state's reporting laws.

MS. DAVIDSON answered, "And to the extent that we can. When you get into medical services, being able to interview clients, there will be things that we have to follow in terms of what is our access to that information. However, the grants do require that these agencies ... report." She noted that the division staff has discussed how to conduct interviews, possibly in the form of confidential surveys, in order to obtain information.

12:59:24 PM

REPRESENTATIVE KERTTULA expressed concern because if individuals have violated the law, and the state is asking about the situation, the state may need to read the individuals their Miranda rights.

SENATOR DYSON highlighted that state law says that the agencies [being discussed] must report suspected violations. He predicted that most professionals report unless they know that the boyfriend is a peer. The aforementioned should be the standard. Furthermore, he didn't believe that there would be a problem such that Miranda rights would need to be read because he predicted that the audit will report how many girls and whether there is evidence that there wasn't abuse in the young girls. Otherwise, the presumption is that a professional will report suspicion of sexual abuse. He pointed out that the professional doesn't have to perform the investigation.

1:01:28 PM

REPRESENTATIVE SAMUELS made a motion to approve Senator Dyson's request for an audit of state grantees' compliance with statutory rape reporting requirements. There being no objection, the audit request was approved.

CHAIR THERRIAULT suggested that if the division faces any difficulty in gaining access to information, it should inform the committee so that it can consider the action it can take in order to help gain access to the information.

1:02:09 PM

CHAIR THERRIAULT then announced that he has a request that the auditor update the recommendations, financial information, and occupational statistics presented in the prior report of the bar association. He explained that the aforementioned request would seem to be a better utilization of resources since the extension of the Alaska Bar Association was only one year.

REPRESENTATIVE SAMUELS made a motion that the committee direct the legislative auditor to revise the scope of the sunset audit review of the Alaska Bar Association in accordance with Chair Therriault's memorandum dated June 14, 2006. There being no objection, it was so ordered.

OTHER BUSINESS

1:03:40 PM

CHAIR THERRIAULT then turned the committee's attention to the next order of business, which is a report regarding the status of the budgets for the consultants retained by the committee. He related that the expenditures went beyond the budget allocation for the proposed petroleum production tax (PPT) because the discussion regarding the PPT went on longer than expected. Chair Therriault indicated that Ms. Davidson had an information sheet that would be distributed to the committee.

1:04:42 PM

The committee took an at-ease from 1:04 p.m. to 1:06 p.m.

1:06:47 PM

MS. DAVIDSON explained that the spreadsheet provided to the committee identifies the five main contractors and the following information: first column - the total contract amount; second column - total amount paid to date. She pointed out that the committee should also take note of column six, which specifies the date paid through. For instance, Econ One Research, Inc. (Econ One), Mr. Eason, and Barnes and Cassio have been paid through the end of April. However, Greenberg Traurig and Mr. Johnston have been paid through the end of March. The last payment amount provides a rough idea as to the monthly payment amount, although one must realize that it will be higher if the consultant traveled to Alaska. The remaining balance column specifies the amount remaining on the contract to be paid to the consultant. She then noted that the contract end date is noted on the spreadsheet also.

CHAIR THERRIAULT commented that this spreadsheet points out to the committee where the contracts are at this point. He then reminded the committee that it potentially faces another special session and when the final contract arrives remains unknown. Chair Therriault informed the committee that as the bills come in, it's likely that some individual contracts will go over [the amount allocated for that contract]. However, the committee is obligated to pay for the services received. Chair Therriault surmised that Mr. Johnston would have input with regard to Alaska's position globally today, but he said he wasn't sure what more would be needed from him. With regard to Mr. Eason's services, Chair Therriault suggested that if the contract is

amended, there may be some continued work for him. He then related that there is a higher probability of Econ One and Greenberg Traurig being utilized as the process continues.

[1:11:06 PM](#)

REPRESENTATIVE SAMUELS requested current figures on the contracts before the committee takes any action.

MS. DAVIDSON agreed to acquire and provide that information.

[1:12:00 PM](#)

SENATOR WILKEN asked whether the chair and the vice chair have a sense of when [and for which consultants] the funds may run short. He then reminded the committee of the upcoming conclusion of the current fiscal year and asked if the committee needs to take action in order to retain the input of these valuable consultants.

CHAIR THERRIAULT directed attention to the end date of each contract specified on the spreadsheet. He pointed out that the contracts for Cassio and Barnes are only through the end of the fiscal year, and therefore it would require committee action should those contracts need to be extended. He specified that the other contracts are approaching the amount allocated or are slightly beyond the amount allocated, the latter of which would also require committee action. He informed the committee that the committee has additional funds in the current fiscal year and the new fiscal year will have the funds budgeted to continue efforts [related to oil and gas contract negotiations].

MS. DAVIDSON informed the committee that in the current fiscal year, there is an estimated uncommitted balance of approximately \$320,000. What is committed are the remaining amounts and those funds have been set aside to pay for the remaining balances. Therefore, there is \$300,000 remaining for this fiscal year. In reviewing the billings, that doesn't seem to be a problem. However, [it's questionable whether] funding for the consultants' activities in the upcoming fiscal year can be achieved with the remaining balances.

[1:14:45 PM](#)

SENATOR WILKEN said that he would look to the chair and the vice chair to make a proposal to ensure when [the legislature] isn't convened, that it won't run out of resources should the services

of the consultants be needed during a special session. Therefore, he expressed his desire to err on the side of appropriating additional funds to ensure that [these services are available]. If this is the time to do so, he expressed the hope that the committee would do so.

MS. DAVIDSON, in response to Representative Samuels, specified that increases in contract amounts requires committee action during a meeting. She related her understanding that if the legislature isn't in session, the committee has to provide three days notice. In further response to Representative Samuels, Ms. Davidson said that she would make calls regarding current balances this afternoon and compile the information as quickly as possible. She expected that she could obtain information related to billings through the end of May.

1:16:50 PM

SENATOR BEN STEVENS pointed out that this appropriation matter wasn't noticed for today's meeting. Therefore, he suggested that the committee may need to err on the side of caution and take action on an appropriation after providing proper notice of the meeting and the subject matter. Furthermore, obtaining an accurate estimate of the outstanding payments due to these consultants [is appropriate].

1:18:03 PM

CHAIR THERRIault clarified that in the interim the committee is only required to provide 24-hour notice of meetings. He agreed that it's reasonable for members to have a full understanding of where the contracts and remaining bills are for these consultants. Chair Therriault asked if Senator Wilken is interested in obtaining a proposed budget for the remainder of the calendar year because the committee is only paneled until the end of the calendar year.

SENATOR WILKEN restated his question regarding whether the committee needs to do something today to ensure that the committee has available to it the resources provided by these consultants past the dates specified on the spreadsheet. Specifically, Senator Wilken asked whether the committee needs to take formal action in extending the contracts of Mr. Johnston and Barnes and Cassio beyond June 6, 2006. He further inquired, "What is our anticipation of the contract amounts getting us to the end of the year or the end of the time that we wish to use them to help us work through these issues?"

CHAIR THERRIAULT clarified that he misspoke earlier because he, as chair of the committee, can extend the contract date. However, he specified that he would like to have the funding authorized to pay beyond [June 6, 2006]. He pointed out that the proposed budget and funding approved for Barnes and Cassio and Johnston anticipated that their work would be completed by the end of the fiscal year. Therefore, anything beyond that would require additional funds.

SENATOR WILKEN expressed his desire to have the experts and professionals available to the legislature in order that the legislature can do work prior to any upcoming special session. Therefore, if the committee needs to take any monetary action today, Senator Wilken expressed his desire to do so.

1:20:54 PM

SENATOR BEN STEVENS reiterated that [such action] would violate public notice requirements because the appropriation item on today's agenda wasn't noticed. He further expressed the need to have a clear understanding as to the amount owed these individuals and the funds that will be remaining after paying them. Therefore, Senator Ben Stevens said that he wasn't prepared to make a commitment.

CHAIR THERRIAULT said that the notice for this matter falls under the "Other Business" heading, but he indicated that it could be specified specifically.

MS. DAVIDSON offered her understanding that the committee wants to obtain an updated amount owed and that the spreadsheet before the committee be updated to reflect that information. She suggested that she should be able to obtain current information reflecting billings through the end of May. She reiterated that she would make the calls to the consultants this afternoon and update the spreadsheet as soon as possible.

1:22:40 PM

MS. DAVIDSON, in response to Representative Samuels, agreed to provide as up-to-date information as possible.

CHAIR THERRIAULT informed the committee that he had just received a press release from the Office of the Governor, which specifies that the governor has extended the public comment period to 75 days and thus it would end July 23, 2006. Chair

Therriault related that he has received a letter from Representative Ramras requesting information from the consultants during the special session. He further related that he has received a request from Representative Gardner for some information.

[1:24:34 PM](#)

CHAIR THERRIAULT determined when members would be available for another meeting.

ADJOURNMENT

[1:25:34 PM](#)

CHAIR THERRIAULT then adjourned the regular portion of the Legislative Budget and Audit Committee meeting at 1:25 p.m.

The committee took an at-ease from 1:25 p.m. to 1:38 p.m.

Presentation by Daniel Johnston & Co., Inc.

[1:38:49 PM](#)

CHAIR THERRIAULT brought the committee back to order for the purposes of continuing the consultant availability on the Fiscal Interest Findings.

[1:40:07 PM](#)

DANIEL JOHNSTON, Owner, Daniel Johnston & Co., Inc., began by saying that he would like to discuss some "fatal flaws" regarding to the fiscal interest findings. He explained that he is an independent consultant, stating that there is a "huge difference between [being an independent consultant] and being an advocate." He opined that the consultants working with the administration have become "advocates."

MR. JOHNSTON went on to say that the Administrations "Government take" statistics in the fiscal interest findings are misleading and inconsistent with previous work and statements. He brought the committees attention to a report submitted by Dr. Pedro van Meurs on February 14, 2006, regarding the contract in Azerbaijan. He said:

Azerbaijan being one of the countries that was being compared, at that time, to Alaska, to provide some

justification for the conclusions that they had drawn. And Dr. van Meurs pointed out that while the national oil company SOCAR (in Azerbaijan) had a 20 percent equity interest in the venture (in the contract he was evaluating), he did not include that in his government take statistics. And the rationale is ... "The national oil company [SOCAR] participates for 20 percent in the venture, but this is almost on a 'straight up' basis and ... therefore is not included in the government take." If you recall, I made quite a fuss about issues like this on [March 6, 2006], when I first testified here in Alaska. I was upset ... that the Wood Mackenzie report upon so much reliance had been made, excluded this very ... aspect of government take. And I didn't find that acceptable. But, in this particular case I did agree with Dr. van Meurs, and for the very reason he points out here.

[1:44:47 PM](#)

MR. JOHNSTON went on to say:

Now, if we roll forward to today, the problem is ... they haven't continued that rationale. In all the government take statistics that we see in the fiscal interest findings, we see that the 20 percent equity participation that is such a big and ... important part of the gas pipeline contract, where the state of Alaska actually pays ... significantly more [than its 20 percent share of the costs, in addition to taking on greater risk than the other interest holders relative to its 20 percent share]. And yet the state of Alaska is effectively paying for that 20 percent ... equity interest ... by giving up its royalty and its severance tax. Why are we trading this different than Azerbaijan? I see no justification whatsoever. I still agree with the way Dr. van Meurs treated Azerbaijan back in February, but I think we should be consistent here. ... We're looking at a contract where, the state of Alaska, like any other working interest shareholder, is going to "pay their way." We'll be heads-up, but instead, the differences are ... more ... in favor of treating it like we would have in Azerbaijan.

MR. JOHNSON turned to Page 3 of his testimony and said:

In my [March 6, 2006] testimony, in fact, I brought in some information from an article I had written in [April 2005] regarding the Libyan license round. In that article, I quoted a World Bank document dated 2003 [which was coauthored by Dr. van Meurs.]

MR. JOHNSON then quoted from the aforementioned report, as follows [original punctuation provided]:

Government take as a result of equity participation by government is really a government equity return, directly paid for by government, rather than a form of government take. Hence, comparing government take statistics by excluding government equity participation is probably a more accurate representation of levels of take.

MR. JOHNSON expressed agreement with this statement. This, he said, is not discussing exploration economics, adding that "therein lies the huge difference." Discussing exploration economics, he said, is "not so simple as just ignoring government participation," adding that government participation is "extremely common."

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MR. JOHNSTON moved on to Page 4 of his testimony, titled "Typical LNG Project Government Take - Existing Projects. This table, he said, comes from a report written by Dr. van Meurs for the state of Alaska in 1997 and shows various existing and proposed projects. This table includes government take with and without participation. On average, the existing projects had an average of 49 percent government take without participation and 68 percent government take with participation. Of the proposed contracts, the average without participation was 39 percent, while the average with participation was 53 percent. If the same format is used on the proposed pipeline, he said, the government take with no participation is 36 percent, and 51-52 percent with participation. He pointed out that all reports discussed have not considered a discounted government take. He said:

In this fiscal interest finding, every ... mention of government take statistics ... are quoted as "real government take." I assumed ... that the discount rate was 3 percent, to convert from "real" to "nominal."

MR. JOHNSTON explained that the table on page 5 uses the "real" take statistics which are generally higher than nominal government take statistics. For all practical purposes, he said, Alaska is "robust" in comparison to the existing 1997 project, and "average" in comparison to the proposed projects from the same year. He pointed out that the Sakhalin II project (Russia) gives a 38 percent value for government take with participation and without participation. He opined that this is not an "appropriate statistic."

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MR. JOHNSTON, referring to page 5, explained that this table applies the same methodology to the Gas Pipeline Contract. He stated that the numbers used can be found in the fiscal interest findings. He pointed out that the government take with participation, at a rate of \$3.50 per MmBtu is 51 percent, while at \$7.50/Mmbtu it is 52.2 percent. This is not, he opined, sufficient progressivity. He said:

To ... more than double [the gas price], [and the] government take only increasing by one percentage point-if we buy into the kind of certainty we are being ... told is required. In my opinion, then, greater progressivity than this is also required. There has to be a balance between the two. And I have always said [that] I don't blame the companies for wanting fiscal certainty for gas. I don't blame them for wanting it for oil. I'm not happy about the demands that they have made-that they have fiscal certainty for both But, there's a chance we're going to go too far and give up too much if we're not careful.

[1:53:03 PM](#)

MR. JOHNSTON went on to say:

Now, [Marianne Kah, ConocoPhillips Alaska, Inc.] ... this morning said "You know, for us, this is a big risk, because [it could make or break the company,] it's such a huge investment." And so I said "well, you could spin off some of that stuff, and spread your risk, companies do it all the time." I chuckled a little bit because [we both knew] how unrealistic that is. Unless they got one heck of a price, and let me

tell you, if they were to take and sell ... a ten percent interest ... this is the kind of conversation you might be able to contemplate between a potential buyer and a potential seller. And as we go through this, think in the back of your mind "why [is Mr. Johnston] so comfortable evaluating government take in this situation, excluding the state participation of 20 percent. Just like I was in agreement with Dr. van Meurs when he did the same thing for Azerbaijan not so long ago.

MR. JOHNSTON then reviewed page 6 of his testimony, titled "Hypothetical discussion between the producers and the buyer of a 10% interest," and offered the following comments. In regard to the 36 percent government take with no royalty and numerous incentives, he said this "makes the deal one of the best on the planet." He went on to explain the state as a 20 percent partner as follows:

What that means is ... the state acquired a 20 percent interest. Just like this potential buyer is contemplating This potential buyer is going to have to pay quite a bit of money, because terms like this, for a deal like this, with as low a risk as this thing represents, is going to be paying an awful lot of money. The state of Alaska paid a lot, too. They gave up their royalty and severance taxes From the perspective of this new interest holder, if they were to buy in, they don't pay royalties, and they don't pay taxes. For every dollar that they invest, they're going to get 64 percent of the profits, full stop. The fact that the state of Alaska is a 20 percent interest holder is not relevant, because there are going to be other working interest shareholders, to the tune of another 70 percent. ... 90 percent of this venture is going to be owned by someone other than themselves, relative to their 10 percent working interest share, they will get 64 percent of the profits....

[1:57:33 PM](#)

MR. JOHNSTON went on to say that "most of the action" will take place during the certainty period. He stated that the certainty period is not "as simple" as it may seem, noting that he would give further detail on this later in his presentation. Moving on to Page 7 of his testimony, he addressed the question "Is

Alaska's bargaining position really so lame?" The answer, he said, is no. Referring to an article from The New York Times titled "As Profits Surge, Oil Giants Find Hurdles Abroad," he agreed that the oil companies have limited opportunities to reinvest. There is, he said, no other opportunity like [the proposed contract] "in the world," adding that he would like to see where else the oil companies would invest.

[2:01:33 PM](#)

MR. JOHNSTON offered an example from previous work with Mobile Oil Company (Mobile), prior to its acquisition by Exxon. In the mid 1990s, he said, reports gave special attention to the Hibernia project off the coast of Newfoundland. This was considered a "fairly large" project; however, Mobile had only 25 percent of the working interest. He questioned how a "relatively small" project "could hold such a lofty place in their portfolio?" He suggested that this is due to the lack of comparable investment opportunities. He pointed out that nationalization of the Alaska North Slope gas has not been considered in risk assessments, adding that "catastrophic failure is a very viable reality in much of Latin America ... and in the Gulf of Guinea...."

MR. JOHNSTON shared a story of his experience in Nigeria, as follows:

I was in Nigeria during [the terrorist attacks of September 11, 2001] and ended up getting stuck there, in Legos, for an extra 10 days. I was a guest of Texaco, at their compound. They were kind enough to ... provide me room and board for those 10 days, while I waited for the airplane service from Nigeria to open up and I could fly back into New York. During one evening at dinner with all the guys at their camp, the head of security for the company was in town, and he was talking about ... a recent raid on one of their platform offshore. A bunch of young men [had suddenly shown up] in boats, at the platform, and tried to take over the platform. Fortunately for the personnel on the platform, they were able to barricade themselves inside the living quarters and fend off these guys. No one was hurt. And I said to the head of security "Jeez, how often does that happen?" He said "About once a month." I said "Once a month-just on your rigs?" He said "yes." And then my response was "Good grief! If it's happening to you once a month, it's

got to be happening once a week around here!" And the response was "Oh, yeah." And then, of course, it's even worse on shore.

2:04:45 PM

MR. JOHNSTON stressed the difference in types of risk. He said:

I really want to make a distinction between bloodshed that occurs in places like that, even today. And fairly regularly-not on a weekly basis, but on an annual basis, no doubt. And the kind of catastrophic failures associated with places like Latin America ... and in the Middle East. ... We don't ever contemplate that kind of failure-that kind of risk here in Alaska. It's a whole different type of risk. We're in a ... class of our own. By the standards of that part of the world, there's almost no risk here in Alaska at all.

MR. JOHNSTON turned to page 8 of his testimony and addressed the question "Is Alaska bending over backwards?" He read from a Fairbanks Daily News-Miner article dated May 21, 2006, as follows [original punctuation provided]:

To sweeten the pot, the administration put together an offer that guarantees the companies their tax liabilities won't increase and has the state shoulder some of the financial risk of building the immense metal straw needed to carry Alaska's gas to market.

"We had to find a way to improve the rate of return on the project without lowering revenue to the state," said Pedro van Meurs, Murkowski's chief adviser on oil and gas. "That's how we decided on state participation."

MR. JOHNSTON then said:

There's been so much pot-sweetening going on around here that it's becoming, a little bit-in my opinion-embarrassing. ... This pot's pretty damn sweet without some of the sweetening that's taken place. And I have another issue, too: That's how we decided on state participation. Is that a fact? Do we know that for sure? Is that the way it went down? I think the

citizens of Alaska probably deserve to know. I'm not absolutely certain it ... happened exactly that way.

MR. JOHNSTON went on to describe "Alaska's backbreaking efforts." These include taking the gas in-kind, fiscal certainty on gas and oil, and a lack of "true progressivity." He said:

I don't blame them for asking for a certain amount of certainty ... but they're going too far. ... They're asking for the ... Rolls-Royce of certainty, but they want to give you a Volkswagen worth of progressivity. They don't want to give up on the progressivity at all. And we saw that just a moment ago, when you go from [\$3.50 per MmBtu] to [\$7.50 per MmBtu] and the government take goes up one point? That's just ridiculous. And, in fact, that's using the government take statistic that includes state participation, when in fact, by Dr. van Meurs words, perhaps that might not be so appropriate. ... All you need to do is see what happens when you go from \$3.50 per mcf to \$5.50 per mcf and you know if there is sufficient progressivity or not. There is not.

[2:10:03 PM](#)

MR. JOHNSTON turned to page 10 of his testimony, which contains an excerpt from the Fiscal Interest Findings regarding taking the gas in-kind. This would result in the state receiving 2 percent less than it would under the 2005 fiscal system. He commented that this is "another of the means by which the state of Alaska has bent over backwards." Moving on to pages 11-12 of his testimony, he briefly discussed the equity position and 35 percent credit for the GTP, in addition to the SGDA guidelines regarding progressivity and back end loading. These guidelines, he said, are not met in the proposed contract.

[2:12:38 PM](#)

MR. JOHNSTON went on to discuss the oil price forecasts. He offered the following quote by Goldman Sachs Group, Inc. [original punctuation provided]:

"Oil prices will be around \$60 to \$65 per barrel for the next five to 10 years, because not enough investment has been made in oil production and refining infrastructure, said David Greely."

MR. JOHNSTON said:

I don't necessarily ... agree or disagree with those price forecasts. I don't need to. Nor do Alaskans really have to care that much whether oil prices are going to be \$200 a barrel or not. And I know I've said it before, but I'll say it again-it doesn't matter what oil prices are going to be-we've got to design this system so that if oil prices and gas prices go through the roof, Alaskans will be able to comfortably say to themselves "well, we accommodated that in the design." ...

I think ... [Professor Doug Reynolds] said it so well. He said ["Most experts believe the future price of oil and gas is \$50 per barrel for oil and \$5 per thousand cubic feet for gas. Few expect it to go much higher, and in fact many experts and companies, including ExxonMobil (1) place an extremely low probability of oil and gas prices going much higher. If that is the case, why is there so much resistance to having a progressive tax above those prices?"] ... That is such a fundamental question.

[2:14:53 PM](#)

MR. JOHNSTON turned his attention to the internal rate of return (IRR) in the fiscal interest findings. Referring to the report done by PFC Energy, he said:

The PFC Energy report that was provided is terribly inadequate and does not provide the information we need to be able to determine if we can trust those numbers or not. So, I did some digging and obtained additional information that I don't think everybody has access to. And it's culminated in this graph here, where some of the key projects that were include in their study are summarized in terms of internal rate of return at \$20 per barrel, and [internal rate of return at \$35 per barrel]. ... The Kashagan field at \$20 per barrel supposedly yields an internal rate of return of nearly 35 percent. At \$35 per barrel, it's [47.3 percent]. Absolutely wrong. Something is terribly wrong here. That defies gravity.

Now, as many of you know, I've done a lot of work in the former Soviet Union, and in particular in Kazakhstan, and I'm fairly intimate with the Kashagan field. I was ... involved in some work and economic analysis of the Kashagan field just a couple of years ago. And, from the perspective of the year 2000, with \$25 per barrel, the field barely yielded an internal rate of return of 15 percent. And here's the thing that's interesting, too: It barely yielded a rate of return of 15 percent, but fortunately, the economic modeling that took place at that time didn't have access to proper information. They underestimated the capital costs in the early period of that economic model, which I was able to find out later. If, they had plugged in the correct capital costs, the internal rate of return would have been much lower. Absolutely. I just can't believe ... I've never seen anything like this. It's so wrong. And it's terribly unfortunate that such a big and important fiscal element was justified on the basis of numbers like this. ...

Some of the justification for the conclusions drawn in the fiscal interest findings [was] based on this PFC Energy report, not just internal rate of return. Net present value and the profit-to-investment ratio metrics, and the other metrics, as well. And I say "that thing is terribly wrong." But, this fiscal interest finding is partial justification for a contract that was negotiated a long time ago, and yet the PFC Energy report that I saw was dated April 18, 2006. Surely, it can't be an afterthought. There had to be additional work that preceded that. How can you justify a contract that was negotiated and agreed upon nearly a year ago, with work that was completed a month and a half ago? The state of Alaska absolutely needs to see what went behind these numbers.

[2:18:06 PM](#)

MR. JOHNSTON, referring to the bottom of page 15, offered his understanding of how PFC Energy came to its final numbers. He said:

Now, what little information I've been able to find in regard to the PFC Energy report is this: One, they've discounted back to the year 2005. And it appears to

me ... that they ignored any costs incurred up to the year 2005. At Kashagan, I can tell you, by the end of the year 2005, the accumulated capital costs were on the order of \$6 billion, if not more. If you ignore \$6 billion, and discount back to the year 2005, you're a full 4 ½ years away from the time that the project was sanctioned. The only way to compare internal rates of return with the Alaska project right now, is to consider what those people were facing when they were wondering whether or not they should sanction Kashagan. In which case, they were facing ... nearly \$7 billion of additional investment than was factored into that report, as I understand it. And in addition to that, an extra lag-time of five years before production began. If you discount, as it appears to me, back to the year 2005, you're nearly five years away from project sanction, so much closer to when production is supposed to begin, and ignoring so much of the capital costs that went into that. But that ... will explain how you can get, for \$35 per barrel for the Kashagan field, an ... astronomical internal rate of return of 47 percent.

Good grief, we've got to get this right. This is embarrassing. I don't want to be a part of this. We've got to fix this, and then stand back and say "do we really need to sweeten the pot?" Because nothing here, that I see, will justify sweetening the pot.

Dr. Kah was kind enough to offer up a little bit of shock, herself, about Agbami, because she knows a little about Agbami, too. Agbami: 37 percent rate of return? No way. Gorgon: 40 percent rate of return? Yeah, you know how you can get a 40 percent rate of return for Gorgon? ... They didn't factor in the tankers it's going to take. At \$170 million per tanker (and it's going to take quite a few tankers, because Gorgon is quite a long ways away from the Asian tigers, where most of those sales will probably take place. [Additionally, if] you don't factor in the re-gas facilities-well, yes, of course then you could start getting some pretty high rates of return. But how can you do that, and compare a situation like that with the huge investment decisions the state of Alaska is making right now?

[2:21:25 PM](#)

MR. JOHNSTON informed the committee that he was able to gather information from the internet on various projects listed in the PFC Energy report. The majority of these projects, he said, are underway, have passed project sanction, and most likely have a "considerable amount of the capital expenditures already incurred." He offered his recollection that, to be included in the study, the projects needed to be pre-production, adding that this is "pretty weak." He then referred to the table on page 16. He pointed out that information from Kashagan is "very difficult" to acquire, as it is bound by confidentiality. He questioned why Alaska should be penalized for the lack of information. He surmised that the study included the manufacturing facility and partial upstream costs, leaving out LNG tanker costs. He said "If we're going to make huge, multi-billion dollar investment decisions on the basis of information like this, we won't be able to face your grandchildren and future generations of Alaska."

[2:23:48 PM](#)

MR. JOHNSTON, in regard to Iranian buy-backs, explained that these are also referred to as "engineering procurement construction contracts." Under such an agreement, he said:

[This] is almost a pure service agreement, where the oil company will come in and fulfill the obligations under a master development plan: build platforms, drill wells, put a production facility in place, hand it over to the national Iranian oil company, and go away. As soon as the national Iranian oil company takes over operations, they start to remunerate and reimburse the oil companies. And, the oil companies in the early contracts (the first one of which was negotiated by [ConocoPhillips Alaska, Inc.(Conoco)]), the rate of return [was] in the high teens. That's what was expected. It was going to be function, to a certain extent, of oil prices, but to a very small degree. Because it really didn't matter what oil prices were - high or low - the companies were going to be reimbursed and remunerated a certain amount. So, the rate of return had very little risk - to a certain extent - in that regard, but there still was some risk. If the oil companies went over budget, they weren't going to be reimbursed for all of the expenditures incurred. But, they also weren't going to have any upside. If oil prices went to \$60 per

barrel, they were still held to rates of return on the order of maybe 19 or 18 percent, and no more. No upside whatsoever.

We have companies like [TOTAL E&P USA, Inc (TOTAL)], who ended up signing the Conoco negotiated contract. And, TOTAL has got to be every bit as big as Conoco, ... [Shell Western E&P] has signed these contracts, too. Here we have companies that are on par with the companies that are operating here in Alaska, and they're willing to sign contracts here that would be unrecognizable in the context of the gas pipeline here in Alaska. But, in my opinion, to a large extent, it's a pretty clear indication ... of what the market can bare. ... The oil companies here are demanding so much more. Now, if you were to fix the problems in the PFC Energy report, which I think are just terrible, not only do we get a better perspective on internal rate of return, and something more realistic, it's going to change the net present value per barrel, ... the profitability index, the profit to investment ratio, and the net present value per barrel of oil equivalent. All of the profitability indicators are going to change, in favor of Alaska. The one thing about the PFC Energy report, as far as Alaska is concerned, they did Alaska right. [The amount of money that has been spent] on the gas pipeline development project is negligible, compared to how much money has been spent on all of those sanctioned projects that were a part of the PFC Energy report. It's just not fair.

[2:27:45 PM](#)

MR. JOHNSTON then gave examples of contract duration for various projects around the world. He pointed out that the average for both the exploration and development phase is 32.5 years. This is inconsistent with the 50-60 year average given by BP. He also pointed out that the table included in the fiscal interest findings, created by Dr. van Meurs, showed an average of 34 years. He opined that it is "not fair to assume" that the production sharing contracts would provide the type of certainty being discussed in regard to Alaska. He said:

Here in Alaska, for all practical purposes, in a variety of forms, both in the dispute/resolution clauses, and the fact that you're taking an equity

position, and [in] various other ways, Alaska is signing away a huge amount of its sovereignty. And ... in my opinion, almost all of it. But, it doesn't stop there. There's a trap with these certainty provisions ... [which we've seen fairly recently].

Imagine you lock in a 30 year certainty for oil. Here's what's going to happen (and the crazy thing is ... the worse the contract is, if you sign a gas pipeline contract that, 15 years from now you realize is a real dog ... and you have to wait 15 years to fix it-then the oil companies know they're in for trouble when the certainty period comes to an end.) So, five years before the certainty period comes to an end, they approach the government and say "We can't justify any more investment for the next five years, because you're just going to take everything away from us. So, unless you agree to provide additional certainty, then we're going to shut down investments right now." I saw that with the first two production sharing contracts ever signed ... Northwest Java, signed in 1968, as I recall, and Southeast Sumatra Those were, as I recall, somewhere around 30 year contracts. About five years before those contracts were about to expire, an ownership of those properties were going to go back to the government of Indonesia. The oil companies said "we can't justify any further development expenditure, because in five years, you're just going to take it all. Unless you agree to extend these contracts, then we're going to quit investing money. And you're going to see production drop off." The government, to a large extent [had their hands tied.] So, they renegotiated those contracts, and gave the companies the same terms, extended the contracts for-as I recall-around 30 years each, [with] bonuses in each case [of] around \$60 million.

If the government ... had been able to take over those operations, and sell those properties for a realistic bonus, they would have [received] \$300-\$400 million, no problem. The value of reserves, in the ground, in Indonesia at that time was such that ... they would have gotten a huge amount. [However,] they weren't in a position to do that. You're on the threshold of a situation like that yourselves.

[2:30:55 PM](#)

MR. JOHNSTON went on to explain another situation in Indonesia which resulted in the government renegotiating its contract. Moving on to page 22 of his testimony, he stated that the gas pipeline contract is "a lawyers dream." He said:

Anytime I see a contract where ... precedent is about to be set, I get extremely uncomfortable. In my experience, in this industry, when something new takes place and enters into the ... contracts ... it usually takes a full 10 years before the contract language evolves to the point that it becomes ... truly workable ... and all of the different possible outcomes and potential false economies have been addressed and accommodated. You're getting ready to set so many precedents in this contract ... and in these agreements. Glued together with the kind of certainty that just absolutely horrifies me.

MR. JOHNSTON, in regard to the dispute resolution provisions in the contract, stated that these "favor the oil companies." Arbitration, he said, is not necessarily cheaper than litigation. It is easier, he said, for companies to "default" on disclosure obligations during arbitration. In addition, he said, the state of Alaska is "an open book," while the oil companies are not, which can be used to the companies advantage.

[2:34:15 PM](#)

MR. JOHNSTON then briefly discussed an article from the Fairbanks Daily News-Miner, titled "Consultant offered different positions on 30-year oil tax freeze. Moving on, he turned to page 25 of his testimony, titled "Cost of Capital," and said:

I put the Iranian buy-backs ... at the top of the scale. ... When the Saudis had the highly touted big three core gas development projects that were the talk of the town about four or five years ago, the one sticking point was internal rate of return. The oil companies were insisting on internal rates of return on the order of the buyback tax rates of return, in the high teens. The Saudis couldn't bring themselves to do it. ... The newer buy-backs, the internal rates of return the oil companies are agreeing to [are] much closer ... to 15-and I've even heard 13 percent. Junk bonds, in the year 2001, at [around] 12-13 percent. Effectively, what they're saying is "Alaska is worse

than a junk bond," if they want a rate of return that's twice what a junk bond will yield.

[2:36:27 PM](#)

MR. JOHNSTON, in conclusion, brought attention to page 26 of his testimony, which contains a full quote by Doug Reynolds, to which he previously referred. In response to a question from Senator Wagoner in regard to the 35 percent GTP, he said:

In my opinion, the 35 percent credit for the GTP-and I think there's more than just the GTP that qualifies for the 30 percent credit-is part of this thesis that I developed of the state of Alaska "bending uncomfortably backwards too far. And, in addition ... to that, are the other credits and allowances that are being contemplated. And so, it's collectively just ... way too much. So, my understanding is: they get that 35 percent credit on the gas treatment plant, and the lateral lines, and various other things. Which means, for all practical purposes, that the state of Alaska is paying more than just they're 20 percent share, their paying an addition to that ... I've heard numbers as high as ... higher than 55 percent. I'd have to think about that and see how it all stacks up. But, if you take the state of Alaska paying 20 percent for their equity share, and then 35 percent for the gas treatment plant, there's 55 right there. So, by world standards, with so many countries in this world who have an equity position, where they pay their working interest share, here you have the state of Alaska paying substantially more than their working interest share, by comparison. In my opinion, if that's what we have to do here in Alaska, to get a gas pipeline, that's one thing. I really don't think that your bargaining position is so lame, and I think once we fix some of the problems that provide justification for the equity position and some of these ... sweeteners, I think we'll find that ... you really do have quite a bit to offer.

The hypothetical discussion about the sale of a 10 percent interest [is] very realistic. From a potential outside investors point of view ... for every dollar they invest, they're only going to pay an effective tax rate of 36 percent. And, for every dollar they invest, the state of Alaska-relatively

speaking-pays a lot ... more. And, by world standards, it's just shocking. If that's what it takes, fine. Let's just make sure Alaskans know how far they're bending over backwards, and if it's really, absolutely needed.

[2:40:01 PM](#)

SENATOR WAGONER inquired as to the what would hold the price of oil at \$60-\$65 per barrel for the next five to ten years, if production decreases and consumption increases. He surmised that this would "drive the prices higher."

MR. JOHNSTON replied that, while he is not an "expert" on oil prices, the fundamentals are "pretty powerful." He stated that oil is a "wonderful commodity" and expressed frustration with the low prices in the 1980s and 1990s. Oil prices have only recently reached a price that more adequately reflects its value, he said. He said "I think there's plenty of reason for fundamentals indicating that it could be more robust, but then ... that's not my area of expertise."

[2:42:10 PM](#)

SENATOR HOLLIS FRENCH, Alaska State Legislature, referred to page 12 and inquired as to how to negotiate a possible counter-offer to the fiscal certainty. He surmised that one possibility would be a lower tax rate.

MR. JOHNSTON replied that a certain amount of progressivity is required. He reiterated an earlier statement that, in this case, more progressivity is needed. He said:

Lower taxes, to a large extent, ... has been addressed. Because, if you consider where we're starting from, ... we're contemplating making some changes that, in my opinion are quite light. Even Dr. van Meurs, as you recall, [was previously] more comfortable with 25/20 ... and had to back off of that. And so, we ... have spent the last three months agonizing over the difference between 20/20 and 25/20 which implies a type of precision which, in my opinion, is just unbelievable. How did we get to the realm where we're agonizing over just-tiny, tiny little percentages? It seems to me [that] it happened by accident. And so, if we end up starting out at even 25 percent tax rate-that is ... quite low. And

starting out at ... 25 percent PPT tax rate for oil still requires progressivity. And still requires ... progressivity that we really, truly, with our hand over our heart, can call true progressivity. I've seen in the fiscal interest findings some mention of "...this is fairly progressive..." they're so mildly progressive, I would call it ... neutral. ... Right now, if oil prices go to \$200 per barrel, with the kind of contract that's proposed, you will all-I guarantee it-have a sick, sick feeling in your stomach. I'm horrified at the prospect.

[2:45:36 PM](#)

REPRESENTATIVE PAUL SEATON, referring to page 5, asked if the government take is only 1 percent, and inquired as to how this would compare to other systems around the world.

MR. JOHNSTON replied that it is around 1 percent, and referring to page 4, explained the difference between the government take percentage both including and excluding state participation. If the state participation is not factored in, he said, the government take is 36 percent, of which 35 percent is the federal income tax rate.

[2:49:00 PM](#)

CHAIR THERRIAULT announced that the committee would take a break and upon returning would begin the roundtable discussion.

The committee took an at-ease from 2:49 pm to 3:02 pm.

[FOLLOWING IS A VERBATIM TRANSCRIPT OF THE ROUNDTABLE DISCUSSION.]

Roundtable Discussion

[3:02:54 PM](#)

CHAIR THERRIAULT: I think we'll start out this afternoon ... I'd like to just -- since Dr. Van Meurs is, I think, the primary author of the fiscal interest findings -- he has listened to some of the testimony here. And Dr. Van Meurs, I'm sorry that you were not able to be here, I'm not sure if agency personnel has filled you in on the items that were discussed yesterday. I would like to give you a few minutes to perhaps just touch on the work that you have done, perhaps respond to some of the

comments that have been made, and then what I'd like to do is go back and touch on some of the bigger issues that have been brought to life. One of them that is -- in my mind -- is the issue of evaluating and comparing a project based primarily on internal rate of return. It was suggested yesterday that that perhaps is not the metric that we should be comparing ourselves to around the world, but it should be net present value instead. I'd like to hear some different points of view on that. But, we will start out -- Dr. Van Meurs that gives you a few minutes to just go over some basic comments and respond.

[3:04:28 PM](#)

PEDRO VAN MEURS, Ph.D., President, Van Meurs & Associates Limited: Yeah, yeah, but just for my information, who is actually present from other consultants and members?

CHAIR THERRIAULT: Okay, we have Dr. Leitzinger with Econ One, we have Daniel Johnson, Barry Pulliam, we have Mr. Van Tuyl with BP, Dan Dickinson, we have Mr. Ken Griffith with DNR, Roger Marks, ... [Mr. McMahon], Tony Finizza, and Marianne Kah.

[3:05:03 PM](#)

DR. VAN MEURS: Now, that's a very distinguished audience. So, I must say it'd be a great honor to kick things off here. Yes, I received a presentation from yesterday, unfortunately I had to travel today from Algeria to Vienna and now literally ... in OPEC headquarters here to try to work on some other matters, but of course middle of the night here and ... so I didn't have 100 percent of the time to review the material. But I for sure have a number of very, very initial impressions. And, if you wish, I can ... comment on that. I think in the past hearings, of course I have given my views enough so it was interesting to hear the views of others. And, if you permit me, I can make some comments on it.

CHAIR THERRIAULT: Okay, go ahead, please.

DR. VAN MEURS: Yeah, so firstly I think ... let's start with the Econ One review and with that I can maybe -- I came at the back end of some the comments of Daniel and I can maybe also make some comments on that as we go along. Now, the first preliminary comment that I would like to make is that ... really I didn't have time to discuss the findings of Econ One, kind of on a professional basis. All I got was the PowerPoint presentation and I had a few hours to review it, so ... that ...

puts me a little bit at a disadvantage in properly understanding. And I didn't see the presentation. So, my comments are therefore preliminary.

DR. VAN MEURS: The first comment that I'd really like to make is on the risk assessment. Tony Finizza took issue with my probability that there isn't significant chance that this project ... may not go ahead ... in the future, which I estimated at 20-30 percent. Econ One had done an analysis where they came to the conclusion that it was 1-5 percent. Now, I really disagree with the Econ One analysis and how they presented our work. What they did is what you call a typical Monte Carlo analysis of two distributions, the cost distribution that's relative price distribution as well as the price distribution. Now, I'd like to make a number of comments on that. First, on the cost. I absolutely never ever represented that the \$20 billion that I had used in the model was the best estimate a) of what this project would cost. And that is implied in the Econ One analysis that I somehow assumed that the \$20 billion that I used in the model is the best estimate, and that therefore the 50 percent cost overrun is a very extreme low probability case. I totally disagree with that. I clearly clarified in the legislature that my data were based on the data in the data room, which date from 2001 and 2003; that all I did was approximately add escalation of 2 percent to it and consequently that that was the database. I also mentioned very clearly in my presentation that I believed that so far there has been very, very significant cost escalation, particularly in Alberta. Where, in other words, that the \$20 billion figure clearly is today an outdated figure, but we don't have another one to work with. Probably a good case to look at ... is the McKenzie Valley line. In 2003 the McKenzie Valley line was estimated at \$5 billion, today the estimate is \$7.5 billion. So, in only three years we've seen an increase in the cost of that line of 50 percent. So, the 50 percent cost overrun case is by no means an extremely remote event as ... Econ One called it the perfect storm. It's absolutely not, we're in the middle of the storm. We're in the middle of the storm for very, very significant cost increases in Alberta because of very tight supplies; labor force very tight supply conditions. And consequently, we are already in a situation where at least with respect to the McKenzie Valley line we are talking about 50 percent more cost relative to 2003. So to portray ... a 50 percent cost overrun as an extremely low probability event or ... suggest that I had suggested that to be a very low probability event is just not ... correct. I ... believe that there is a very high probability that the costs of the \$20

billion that I had estimated are significantly higher today in 2006 than I used in the model. So, we are not talking about the perfect storm; we are in the middle of the storm. And it is already clear that cost overruns will be likely high. At the same time, it was kind of implied in ... the Econ One material that

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DR. VAN MEURS: ... the price forecast that was used in the fiscal interest finding was a triangular distribution between low, average, and high. I made it absolutely clear to the legislature when I presented these that I don't believe in those kind of probability distributions that it is my view that the U.S. American market is an extremely volatile market, and therefore I absolutely disagree with making the price distribution a triangular distribution with the low price absolute of very low probability. And therefore, I just don't believe at all in this so called perfect storm argument. And consequently, that's the reason why I think my estimates of the possibility of failure of this project are much higher than what's calculated, ... supposedly based on my data by Econ One. And as I said, I fundamentally disagree with that assessment.

DR. VAN MEURS: Another issues with the matter of decision-making. Firstly, let me make some comments on the PFC database. I must say, I take a little bit of exception of the comment of Daniel Johnston that kind of implied that we just cooked up that database ... just a few weeks ago to prove our point. That's absolutely incorrect. We have been looking with PFC energy ... ever since the end of 2004, and consequently the study that was done was merely an update of what was already done earlier. So consequently, we have been touch with PFC Energy on trying to properly ... monitor ... try to place the Alaska gas project in the world context already for ... one-and-a-half or more years now. So consequently, ever since the end of 2004. So consequently, ... the relationship with PFC Energy has been ongoing ... on this matter. And in fact because we had the relationship, in fact ... the legislature actually also contracted them. Is the database of PFC Energy 100 percent satisfactory? It isn't of course, but it is unfortunately the only commercial database that was available to me. In 2004-2005 I reached some of the same conclusions that ... I heard also Daniel make, that some of the projects were not properly reflected. ... So consequently, the database was not 100 percent satisfactory. As a result of that we did a number of independent tests. We had Wood MacKenzie work on say the Ormen

Lange field. I actually were able to work myself Qatar gas with PFC Energy. But obviously during the last month I was busy with a ... very important piece of legislation, which was the PPT legislation and I couldn't set aside those three weeks to kind of go through the whole database. I'm ... absolutely convinced that the database is not perfect. Econ One makes the comment that there's quite a bit of non OECD countries in there. Correct that there is a large number of deep water oil fields in there, that's correct, that tend to push the rate of return up. I also agree with some comments that some of the LNG projects only reflect upstream, that also pushes the rate of return up. So the database is not perfect. I was perfectly aware of these things, and consequently in my evaluation of the Alaska gas project I took all of that into account; so consequently ... we made corrections in 2004-2005, and in fact those reports are also available. And consequently, ... that's my view on it.

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DR. VAN MEURS: Comments were also made as to evaluation criteria, that you can't use rate of returns if you're well over the, say, cost of capital as a rating criteria. I would agree with that. I think many economists would agree that ... by the time you get to 32 or 36 percent rate of return, that the project of 36 percent rate of return is not necessarily more profitable than 32 percent rate of return. That is a very basic concept. And do I agree that profitability ratio is an attractive way to rate project ...? Yes, that's precisely what I said in the legislature; I agree with that. And that is why I presented to the legislature not just the rate of return, I presented all the profitability criteria. I explained precisely the importance of each of the profitability criteria and I explained the great importance of the profitability ratio, particularly in rating projects. The fact that you would not necessarily use a rate of return under very high price conditions and at very high rates as a rating criteria doesn't mean that you have to go completely overboard, as I think Econ One does and absolutely declare a rate of return as a totally irrelevant profitability indicator. I think that it is absolutely wrong to state that rate of return is not important. Definitely for the study of a project, particularly on the downside conditions, particularly under the conditions of say possible low prices or ... cost overruns, when rate of returns become relatively low, the rate of return is of immense concern to oil companies. It is a very important profitability indicator and maybe not so much for project rating or ranking, but definitely for project analysis. And consequently, I just

completely disagree that you should disregard rate of return if you are studying downside scenarios or even average price scenarios as we have in Alaska. But the Econ One seems to agree with the fact that the rate of return is somewhat low. The low rate of return truly is a concern to investors, and consequently that is why the gas contract was structured the way it was. I think it is just very extreme to say that rate of return has no bearing or is not important or is ... not used anywhere in industry for ranking or for analysis. That is just entirely wrong. My experience around the world is that rate of return is an extremely important indicator.

DR. VAN MEURS: Econ One states that ... they believe that this project is the largest in capex, that it has the best net present value at average prices, that it has an average profitability ratio at least kind of all based on kind of my data, that it has an acceptable MPV over the oil equivalent. Yes, that's exactly what I presented to the legislature, I've never had any disagreement with that. All I can say is that Econ One seems to agree with me on that score. I have always clearly stated in the legislature that the net present value at average prices or high prices is the best in the world. That is how I described it in front of the legislature and I also clearly stated that the profitability ratio was about average. So, I have no disagreement with that and that was not the basis on which the fiscal design was made. The fiscal design was made on the fact that I firmly believe that the low rate of return of the project is a concern to investors.

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DR. VAN MEURS: I also tried to review Barry Pulliam's say extensive economic analysis. Unfortunately, there were just lots of figures and there was no particular explanation as to ... why his findings were different from my findings. I would've preferred if we could've ... gotten together and we could've kind of ... reviewed each other's results and discuss it before ... we get ... thrown in this meeting because I really don't understand where the differences are coming from. One thing is clear that Pulliam's analysis seems to show considerably lower royalty and a considerably lower revenues for royalties plus the severance tax than I have. And I'm somewhat mystified how he comes up with that because we have the same royalty rate, the same severance tax rates. I had already taken account of the UCA, ... the marketing cost, and ... he seems to come up with much lower figures than I have and I have no explanation for it. So, I don't know where his model comes

from. I have provided my model to everyone, to Econ One and everyone who wants to see it. I have not seen Econ One's model ... so ... I could not understand where these differences come from. So, all I can say that it seems that the figures of Econ One result in lower values for ... royalties and ... severance taxes than I came up with and I don't know why. So, hopefully in the future we can maybe review those differences.

DR. VAN MEURS: From a broad perspective, though, I believe that Econ One seems to concur with a number of conclusions that I also had reached, which was: point one, that indeed there is a material improvement in the rate of return to the producers as a result of the contract; two, that the government take in my case is slightly less and in Barry Pulliam's case is somewhat more, less than the status quo. And we also both agreed that ... differences increases if we start to discount. So, I think broadly speaking we seem to be coming to the same conclusion. The numbers on government take don't seem to be too far off either. So, I believe ... approximately we seem to get the ... same results, but as I said, in detail I don't understand the figures and I would really need to sit together for a while to really properly understand them. That's as far as Econ One is concerned.

DR. VAN MEURS: Just some further comments on ... what I heard ... from Daniel. Firstly, yes I agree with his statement about ... state participation, that you can break that out. I like to remind Daniel that the state is not participating in the upstream, and therefore the state already owns the gas, ... tax gas and the royalty gas, and therefore the state is not participating in the upstream. And therefore, I do not agree with his calculation as to that ... you have to take 20 percent government take out. The state is only participating in the midstream, so consequently that is where I would definitely put a different view on things. Because ... the state is not participating in the upstream and because our shipping and marketing commitment is such an integral part of the deal, I added the modest revenues that we get from the midstream to the ... government take, although I recognize that ... you can also take that separate. And in my economics report, I ... give the figures either way and I have no problem to break that either out or to combine it. So, I don't agree with the 1 percent number that was thrown around because the state does not participate in the upstream. It is not ... similar to some other straight up agreements.

DR. VAN MEURS: Also some comments were made on the relatively low rate of returns in Iran: the 14 percent, 16 percent. I think I know Iranian contracts very well and I think having worked considerably in the Middle East, I ... think his perspective of why TOTAL and why Shell are signing these deals is not correct. I think yes, the upstream part of these deals is ... a relatively modest rate of return of 14 to 16 percent. ... On the very large gas projects that they have signed up for, both Shell and TOTAL really made their money on selling the gas. So, there's ... a joint marketing agreement between New York and companies whereby significant profits are being made on the marketing of the gas itself. And consequently, that is why these relatively low rate of return contracts under the buyback agreements are attractive. And I don't think, therefore, you should use that as an example that those rates of return are ... acceptable to the industry. Both TOTAL and Shell make most of their money downstream, they don't make their money in the buybacks. So, so that is another comment that I would like to make on that.

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DR. VAN MEURS: ... some comments ... that Daniel made on progressivity as you all know I'm very much in favor of progressivity and I'm quite happy with the PPT and I still very much hope that one day this the PPT bill will pass because I think it will be very good for Alaska to have that law and this ... strong progressivity on oil. I did quite an extensive analysis ... on our competitors as far as gas. And although I agree with Daniel that progressivity is a very extensive feature used in some cases around the world for oil; although Daniel also agrees that there are very many fiscal systems that are not progressive. Actually, for the last large gas exporters, progressivity really means cutting government ... take down if prices go down, it doesn't mean adding to the government take if prices ... go up. We've seen that in Canada where ... there is a special rate of return situation. We've seen it in Australia, ... Indonesia and so consequently, in gas, actually as soon as you get over \$2 or \$3 per million Btu at the wellhead, all of the ... fiscal systems are pretty flat. And consequently, I do not necessarily agree that ... for large distance gas exports ..., progressivity is a worldwide phenomenon; it is not. Progressivity is not a worldwide phenomenon for large distance gas exports, and consequently Alaska is competing with that. Also, I ... think we should not necessarily simplify the matter of progressivity too much. I think Daniel agrees with me that government takes on gas around the world are less than oil and

the big problem that we're having here and that makes Alaska so different from most jurisdictions in the world is that of course, Alaska is a state of the United States and the government take is a combined government take. Most ... or in fact all of the counties that Daniel is referring to, the state are unitary states and have, therefore, far more flexibility to construct progressivity than Alaska has. ... To say that Alaska should necessarily construct the same level of progressivity as other unitary states do, it is just not 100 percent possible. And consequently, I think we need to remind ourselves that no matter what, the federal government takes 35 percent government take no matter what we do. And that ... is a very important limitation on how far you can go, particularly in large distance gas exports, with your fiscal structure. So, ... these are just some very, very preliminary comments that I would like to make.

CHAIR THERRIAULT: Okay, thank you Dr. Van Meurs. I'd like to start off now with perhaps -- I saw Marianne shaking her head when you were talking about internal rate of return. And I think some of the follow-up questions that were asked today when members were looking at some of the Econ One presentations today that talked about IRR. And yesterday we had heard that we shouldn't put a lot of stock on IRR and when I asked for the clarification, ... my take on the answer that I got back was that it certainly is a good metric to look at evaluation of a project ... itself, but perhaps doesn't lend itself that well to a worldwide comparison. And so, perhaps we could have a little bit of discussion on that. Marianne, since you were shaking your head, why don't you start off.

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MARIANNE KAH, Chief Economist, ConocoPhillips Alaska, Inc.: I'm glad my body language is so visible. First of all ...

CHAIR THERRIAULT: Pull the microphone just a little closer, if you can.

MS. KAH: Okay, can you hear me?

DR. VAN MEURS: Yes, perfectly.

MS. KAH: First I wanted to say that companies really do look at a range of measures; we don't look at one measure. And IRR is a very important measure that we take very seriously. We also take some measures seriously that economists, including myself, really gasp at: return on capital employed. A very important

measure to us as an accounting measure and economists hate it, but Wall Street pays attention to it, it actually access price-earnings ratio, in terms of stock prices. So it's very important that we look at return on capital employ and make sure we don't invest in a project that will have such a low return that it will dilute our return on capital employed. We also, of course, do look at net present value. But I would like to comment that if it is true that this project ..., the Alaska pipeline, has the highest net present value of any project in the world that that's because it requires the most investment and it's the largest project. That doesn't mean the returns are going to be commensurate with that. ... Some of the comments that Econ One made about the way we look at projects and even discount rates that we use, I would disagree with. Our industry doesn't necessarily use the 10 percent discount rate. And I think you even presented some material yesterday indicating that a U.S. risk discount rate was more like 12 percent, and that's for the U.S. in general. If you looked at the energy industry it would probably be higher than that in terms of the risk involved in energy projects in the United States. ... and this may sound like a small detail to people, but ... you even said in your analysis yesterday that 1 percentage point in a discount rate is worth \$5 billion in MPV [market present value]. So if you, for example, increase that discount rate by 3 percent you would have the MPV that you were showing in your economics yesterday. So, I'm not saying what the correct discount rate is, I can't tell you what one we use, but I will just say that that is not common practice. And a lot of things that may be, you know, economically the most robust things to do or technically correct, maybe that does not withstand practice in the financial community and in the business world in terms of what we look at. I would like to close by saying that this project really is not like any other project. I think most of the projects that we looked at in the comparison were \$5 billion or less; this is in a class by itself. We don't look ... the same way we would look at any other project because it is large enough to have a significant impact on not only our company but on ExxonMobil in terms of if things go bad, destroying the return on capital employ, which is of course how shareholder value is created. And our shareholders are pension funds, you know, retirees. You know, we have to have the judiciary responsibility to make sure we don't put these people in excess risk in their profit. So, this is a different project; we have to look at it differently.

MS. KAH: And I don't like any of the comparisons with other countries because it is in a class by itself, in terms of the

greater amount of risk this project has. And risk in terms of the amount of capital, the time it takes - the world could be very different in 25 years. I mean, don't kid yourself, you had two decades of gas prices at \$2. I'm not going to say that's going to happen again, but 45 years is a very long time period. And so, when you have a project that's this large and takes that many years to develop and has such a long life, just the magnitude of risk is that much greater than anything else you would consider. So, you know we're committed to making this project happen, but ... the most important thing to us, particularly in terms of fiscal certainty is risk mitigation. So, I'll stop there, but I hope I can get another chance to talk about risk later.

CHAIR THERRIAULT: Yes, thank you. And what I'd like to do, as we bring up one of the topics to discuss - and legislators if there's something that you, through the presentation, thought was ... some of the salient point ... that you're taking away but you have a question on it, we'd like to get that up for discussion. Not necessarily looking for everybody at the table to weigh in a particular issue, otherwise we'll talk about one or two issues and then our time will be done. I'd like to go get ... - Mr. Van Tuyl indicated ... that he wanted to weigh in on this one in particular, and then perhaps ... we'll get a response from somebody with Econ One.

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DAVID VAN TUYL, Commercial Manager, Alaska Gas Group, BP: Thank you Senator Therriault, Dave Van Tuyl with BP. I guess a lot of what I'm going to say will echo what Marianne said and I'd also like to weigh in on a couple of other topics, including risk as well. The financial decision-making presentation offered by Econ One isn't reflective of how BP evaluates projects or makes investment decisions. There are a number of variables and key performance indicators that are analyzed, many of which weren't included in those referenced by Econ One. Those key performance indicators and variables include the financials, ... cash flow. In fact, a long-term cash flow is essential in evaluating a project like this. As Marianne said, it's a long-term project ... and that's a particular characteristic of this project. And that kind of underpins the need for certainty; we really need to know what the rules are. If we're going to be spending cash, outputting cash for 10 years while we develop the project, some \$20-\$25 billion, maybe more hopefully not more. And we won't get any return during that period because first, gas won't have occurred. After that

period, it will take decades to amortize that investment and that's the reason why we need to know during that period and during the period it takes to actually start turning a profit, we need to know what the rules are. And it's not unusual for mega projects around the globe to have that sort of an arrangement. Certainly in the Caspian Basin those contracts are available in the [Baku-Tbilisi-Ceyhan(BTC)] project that BP is involved with. That contract actually has a 60-year term. There's actually four developments that are associated with that: a gas project and a oil project both, one has a 40-year term with 2 optional 10-year extensions, which adds to 60 the other is 60 years. That's because these are mega projects, big investments; you need to know what the rules are and they take a long time to payout.

MR. VAN TUYL: Just one comment on risk before we Just by its nature a single \$25 billion investment is inherently risky, but it's manageable. The risk is manageable. Five billion dollar investments would be inherently less risky. And yesterday, I think, was the first expert testimony, I'm aware of, that has characterized this as a relatively low-risk project. I would say that as resource owners, the producers are commercially motivated to manage that risk, to manage the project costs down because we want to maximize the return on our gas resource. We share that incentive with the state, but it doesn't happen by accident. We have to be able to manage that risk because, as Representative Samuels mentioned, ... if you get a \$25 billion project going sideways, you're not talking about a 10 percent cost overrun or a 20 percent cost overrun now you're talking about a 100 or 150 percent cost overrun, which has happened on mega projects. And that's what we're trying to avoid by managing costs. I would like to come back to that in more detail.

CHAIR THERRIault: We'll ... touch on this some more. We'll go to Roger and then we'll have somebody from Econ One, perhaps, just touch back on this issue of the IRR versus the MPV or other econ metrics that should be used.

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ROGER MARKS, Economist, Department of Revenue: A couple thoughts on the IRR. The IRR measures one very important thing: all projects need money; the money comes from debt, the money comes from equity. What the IRR measures is can you repay creditors, can you repay your shareholders commensurate with the risk they occur. That hurdle rate or the ability to repay them,

the weighted average cost of capital, that's what you have to exceed to make the project viable in just that one metric. So, if ... you know what the hurdle rate is, you see what the IRR is. If you exceed it, you've satisfied one criteria of the project, there's other things you have to look at. That's simply what the IRR does; it's very important for that. There's one criteria you have to meet. Now, I ... also believe ... you can't ... look at all kinds of projects and just compare their IRRs. Again, ... this weighted average cost of capital, your hurdle rate, reflects the risk that ... investors perceive. You're cost of equity, that's embedded in the WAC, reflects what the business risk that investors see. There's a phenomena in investment where ... people seem to under appreciate or under recognize what happens if a low probability event occurs. Often, a low probability event will occur, which wipes somebody out. The technical term they use for that is called blowing up. Accompanying investors are becoming increasingly savvy about - investors do not look at downside risk and upside risk symmetrically ... something bad happening is much worse than what is good if something good happens. With a project like this ... what the perceived cost of equity is going to be, it varies from project to project to project. These hurdle rates vary from size project to project to project. So, you can't really compare - I can't rank order projects based on their IRR. I have no idea what the hurdle rate for this project is, I'm pretty sure that three companies here have no idea what it is either, at this point in time. It's going to reflect, again, the risk of the project and ... how they see how bad a downside scenario is. On the MPV, I think I'll just echo some comments once made before. You can have 25 \$1 billion projects whose MPVs are higher than the MPV of this \$25 billion project. ... MPV means you have a big project, that's it. I actually had some heated discussions with Pedro about this metric. I ... discount it considerably because all it means is you have a big project, end of story.

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DR. LEITZINGER: I'm going to be presumptuous for a moment and ... suggest that I think the responsibility and the challenge that the legislature faces in this situation is to understand in an objective, sensible way, prudent way the tradeoffs that are being posed of the contract, in terms of the concessions. And it is in that role ... that the fiscal findings ... take on a very important capacity. Those findings provide the basis for the decisions about the contract and the tradeoffs. I ... firmly believe, having read the findings several times, that the

basis for the ... conclusion that the gas was stranded and the approval of the concessions was that the gas, because of its transportation cost, operates at an internal rate of return disadvantage compared to projects in the rest of the world. What I am hearing in the comment is that well, we look at IRR, it's a measure, but there are other measures that we look at. And, in fact, you can't use IRR to compare across projects in the world. And, in fact, this project is unique and shouldn't be compared against projects in the rest of the world. And that the problem with this project, instead, is it's \$25 billion, it might go sideways, we have to manage cash flow, by the way we don't use 10 percent rates of return, we use a higher number but we won't tell you what it is. I think the difficulty that that poses is ... it's not the case that was made in the findings. And if, indeed, that is the reason the State of Alaska should accept the concessions, it seems to me that ought to be laid out in a way that people can look closely at the argument and evaluate it, and decide really in the end whether that ... that provides an adequate basis upon which to believe this project is challenged.

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DR. FINIZZA: ... I think the preface of the roundtable is to try to get everyone's views on the table and see if there are any differences. And I think maybe it might be useful to comment on some of the comments I heard that pertain to me. ... But I find myself in agreement with a lot of what Marianne and Roger said. ... Also Dave suggested some things that I know to be true as well, although cash flow isn't an element of our analysis. I would suggest that perhaps the -- we saw a number of 12 at the market rate, the petroleum industry is probably is lower not higher. We would say 10 percent because ... I remember their (indisc.) of the industry were below one at one point, if they had something to do with it. ... Oh by the way Pedro on page 8, I did make a typo and said triangular distribution for the price distribution, ... the title of the slide corrects that, it's really a different distribution. I do think you've avoided the question Pedro and the question ... is: how do you get 20 ... to 30 percent chance being uneconomic for those two factors. Is this an analytical approach or is it subjective probability with some ... chance of overruns, et cetera. That would be very helpful to decision makers to see if you could quantify this a little better. Because if it's a subjective probability, you could've said 50 percent. Also, I think that in your ... analysis of using the IRR, which we all seem to agree is not a good ranking measure, it is the key one

used in comparing international projects. The fiscal findings set up an arbitrary measure threshold of 20 percent, the lowest 20 percent is where you find the Alaska project before the contract and magically it moves slightly, but appears in the fourth quintile after the analysis. Most people I know use quartiles, but it doesn't matter, it's still at the low end and it hardly moved. My final point is if this really is serious cost overrun issue here, it's going to remain with the contract as well as pass forward. I'm sure I'll get another chance to come back, so I'll turn it over to Barry.

CHAIR THERRIAULT: ... Dr. Finizza has touched on number of the risks of the project not being completed. Do we have anything else on using the IRR, in particular, as a comparative tool. Or, ... -- and there's a suggestion that the fiscal interest findings are built primarily around IRR, but there's some suggestion that many other things were ... utilized. And, I think ...

DR. VAN MEURS: If I could comment on that?

CHAIR THERRIAULT: Just a second Dr. Van Meurs.

DR. VAN MEURS: Oh, sorry.

CHAIR THERRIAULT: For myself, I think ... if there are a set. If IRR is one and NPV is one and there a number of others that we should look to see how the project stacks up against others. Maybe it's the winner in one and the middle in another, and it's the loser in the third one. If we're to look at a suite of a metrics for comparison purposes not just IRR, we need to know that. And so, Barry did you have a last comment on that in particular?

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MR. PULLIAM: Yeah, ... I will comment on the IRR. I think I just want to go back and echo some of the discussion I heard about the PFC data from Daniel and then also from Pedro. If it is the case that that data is not satisfactory and if it is the case that there is capital left out there whereas we're including capital here, we ... really aren't making a meaningful comparison with that information. And to then use that and ... at least put a great deal of weight on it, I think, is ... problematic. But the point on IRR is ... -- Dr. Van Meurs mentioned that he didn't understand some of the numbers that are in my report, I appreciate that he hadn't had probably any time

to look at and I'd be happy to sit with him some time and go over those and show him where I think the differences lay.

CHAIR THERRIault: Roger.

MR. MARKS: Ranking issue aside on the IRR, what's important on the IRR in this contract is how much ... the contract bumps it up. Again, we don't know ... what the hurdle rate is for the companies, but ... if you can bump it up, you've gone a long way to making the project feasible. Again, ... depending on ... what the prices and costs ... the IRR goes up about two percentage points. In the calculations I've done, that's ... the financial equivalent of ... almost \$1 per million Btu, which on 50 trillion cubic feet is a lot. It's the financial equivalent of about \$4 billion in capital costs. So, ... let's not dismiss the IRR. The fact that this contract bumps it up is ... very, very important.

CHAIR THERRIault: Okay. Let ...

[3:49:41 PM](#)

REPRESENTATIVE SAMUELS: Question, thank you Mr. Chairman. As the comments go around I'd like to know what different methods are used industry wide or are the industry people in your particular company solely based on the size of this project. ... is it a \$1 billion project [for which] you look at all 10 different metrics? Or, because of the size of this, are you also adding different metrics.

KEN GRIFFIN, Acting Deputy Commissioner, Anchorage Office, Department of Natural Resources: Before we go to that, let me ... rephrase or provide a different perspective on what Roger just ... shared. From a project management standpoint, the IRR provides some assessment of the project's ability to handle adversity. As Roger said, this IRR goes up ... two percentage points, that's maybe a 10 percent improvement; that's a \$1 in mcf per million Btu improvement. That is a significant improvement in the ability of this low rate of return project to handle adversity whether that comes along due to cost overruns, ... delays, ... low prices. And, you know, those are three risks; those all have a bunch of components. And we don't have a simple project with just three simple risk areas that we're trying to manage. We have a massive project that has enormous implications. As Mr. Van Tuyl from BP said, ... overruns of 150 percent are not unreasonable for a project like this. And so, seeing a 10 percent improvement in a rate of return

significantly improves the chance that neither the corporations nor the state will be destroying value as a result of this investment.

CHAIR THERRIault: Dan.

DAN DICKINSON, CPA, Consultant to the Governor: My issue is, of course, that the justification for trying to improve that rate of return was based on the data from PFC Energy. And Kashagan is the one that I use because it's one with which I'm intimate, but it's also the highest internal rate of return of all the examples and it's higher by a factor of about three. Three times greater than what it should have been if it would've been analyzed properly, in which case it would have been ... difficult to justify the increase in the internal rate return. Secondly, there is some downside if you're the only fool to get involved in a project that's too big for your company, that's a manageable risk though. If it's so big that ConocoPhillips runs the risk of ruining their company, then they can sell half of that thing and they diversify out. It's part of what we call sometimes "gambler's ruin"; don't put too many eggs in one basket, it's as simple as that. And you'll get a pretty good price for it too. There's another aspect that has been mentioned as far as the internal rate of return is concerned and as large projects are concerned. Money has value, we all know that. Money is like a piece of equipment: if you don't put it to use it's a waste. ... One of the means by which we measure how useful it is ... the internal rate of return and I don't have problems with using that metric. I do have problems with the way we've compared it to other projects around the world, that's really, really bad. I did not mean to imply, Dr. Van Meurs, that you are cooking the books It just was a little curious when I looked to see the supporting information that it was a report that was six weeks old, and it wasn't something that really lent itself to a detailed analysis when so much was riding on it. Now, when you have that much money or the opportunity to put a large amount of money to work, very often companies know that ... if you can \$5 billion to work in one project as opposed to \$500 million to work in 10 different projects, there's an efficiency there. And a lot of times companies are willing to accept a lower rate of return because the rate will have put so much at work with so little management. It takes a lot more money and effort to manage 10 projects as opposed to one. So there's two sides to that coin and that's one of the virtues of this project. Now, Mr. Van Tuyl brought up an example of a situation in the Caspian, ... BTC pipeline where they have 60 years and it's a flat contract.

Now that's a nice but rather unique example. Let's think about what's going to fill that pipeline, Kashagan. Kashagan is the one project of all the projects that we've talked about that is equal ... to the gas pipeline project in terms of capital expenditure expectations: \$25 billion good working number. And ... if BP really believes that it had a rate of return potential of 34 to 47 percent, they never would have sold out their interest. The other two of the big producers here are still involved in that project, and that thing has changed twice. The government has swooped down and made unexpected and noncontractual changes that they've imposed on these guys just within the past four years. About four years ago I was in Astana, Kazakhstan and they showed me that the operator, ENI, had announced that they weren't going to start production in the year 2005 and the prime minister of Kazakhstan felt that was a breach of the contract. Let me tell you, it wasn't even close to being a breach of the contract. There was some language in the contract that had some ... best efforts language and things like that, but the companies were simply not obligated to start in the year 2005. But the prime minister ... felt that it was sufficient breach to justify him levying a \$150 million signature bonus or additional bonus on the companies, which they paid. Not widely known, not widely published, but that's the kind of thing that really irritates oil companies, and I don't blame them. But it's also the kind of thing that's extremely unlikely to occur here in Alaska and even in the absence of the kind of certainty provisions that are being asked for. So, yeah BTC pipeline might have the kind of certainty that people would expect, but upstream from that just a little ways, the Kashagan field is going to see that it's extremely uncertain and there's no way you guys would've gotten that kind of certainty in that contract, not at the time of contract signing or now.

CHAIR THERIAULT: Dr. Van Meurs, did you have perhaps a wrap up on this issue of whether IRR is the correct metric to ... build the fiscal finding on? And then a number of people have brought up overall risk, and so I think we'll turn our discussion to the risk. So, Dr. Van Meurs.

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DR. VAN MEURS: Yes, now again I ... agree with a lot of the comments that ... were made around the table. I'm happy that ... the consensus seems to move to the fact that indeed, rate of return is a very important factor and should not be disregarded. And I think ... there's misunderstanding point one: how the rate of return is being used in the fiscal interest finding and

how we used it in our work. ... Firstly, as people should know, I have presented not just the rate of return to the legislature. I went systematically through all of the profitability indicators, including the cash flow And the concept is based on the analysis of all these indicators, not just the rate of return. And the reason that we focused on the improvement of the rate of return; it was precisely because we concluded that with respect to many of the other indicators there didn't seem to be much of a problem. And consequently, it was just the rate of return as well as net present value under ... per barrel equivalent under some low prices that needed some improvement. And that is why the contract is constructed the way it is constructed. I think we also should make a bid distinction between using ... a profitability indicator as a rating criteria, which is really meant to stack project, or as an analytical tool. ... I agree that at very high rate of returns it doesn't make much sense to use rate of return as a rating criteria. Nevertheless, in the fiscal interest finding the rate of return was important from the point of view of analyzing the downside of the project By improving that rate of return by 2 percent, we really give this project much stronger position to actually be successful, survive cost overruns, and so on. So consequently, the reason that we focused on the rate of return is that that was where the weakness of the project was. And did we entirely decide on the PFC Energy report? As I said we didn't. We did alternative reports, we did alternative work, we did not just use the PFC Energy work to ... conclude that. And consequently, it was based on a very broad gamma of analysis, not just this particular rating. So consequently, that is common that I would have on the rate of return, but I'm happy ... people seem to believe that rate of return is, indeed, an important indicator then I think that ... is definitely important.

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DR. VAN MEURS: The next thing is the question that Tony Finizza asked about the risk profile. Yes, ... I argued relatively strongly when I gave the presentation to the legislature on very detailed probability distributions trying to predict the future. He gave in his presentation examples of the Lukens Study for answers on prices. Now, I went through the Lukens Model in some great amount of detail. Lukens is a professional consulting company, they built a good model. But, the model just is ... an input-output model and ... the whole price forecast, distribution depends entirely on the assumptions you put in.

And consequently, ... definitely, I see models of that nature more as a ...

4:01:00 PM

CHAIR THERRIAULT: Dr. Van Meurs. We lost the line with him. So, Dr. Van Meurs was starting to talk about the risk and all that falls under sort of the umbrella of risk. And who would like to - Marianne. ... Let me just touch on -- it seems ... the things that I've heard sort of underneath that umbrella is ... with regard to risk, that Alaska is ... stable government, we have known reserves. As far as cost overruns ... all the infrastructure that's currently producing the gas and reinjecting that's a sump cost. The size of the project and the size of the remaining investment that would be needed and the possibility of cost overruns, is, of course, there. And then the risk of noncompletion. So, I don't know if you've got other things to sweep under that umbrella.

MS. KAH: No, that covers a lot. I did want to talk about risk. But first if I can quickly comment on the 12 percent return for the U.S. industry, or the discount rate. I would argue that as a whole energy industry we probably do have lower cost of capital than that. However, for the whole portfolio if you're looking at a specific project and the project is riskier, you would use a ...

DR. VAN MEURS: Hello.

MS. KAH: ... more risk adjusted return. Sorry, Pedro, I sort of took the floor while you were gone, but I'll be quick here.

DR. VAN MEURS: Oh, I'm very sorry somehow somebody didn't like me to talk about risk, I think.

CHAIR THERRIAULT: Well, you ... had started the debate and Marianne raised her hand and then we have Mr. Van Tuyl.

DR. VAN MEURS: Oh, okay ...

MS. KAH: ... one quick comment to Daniel Johnston. I think the risk are manageable, it's just that they're large and we need to find ways to reduce some of the other uncertainties. I think there is significant cost overrun risk; there are significant market-related risks. And the way you manage those risks is the state doing what it can to reduce some regulatory and the fiscal structure risks. It's all about risk management. And with

that, let me just launch into my views on the risks. First, on the side of capital. Pedro, you talked about this earlier. If you looked at the range of risk on capital cost overruns that Econ One showed, we may well be today at the upper end of their range, just based on a hyper inflation and cost we've had in our industry today. So, that may be the mean or the likely case upon which you actually put your range around. Now, of course, we don't know ... what the cost structure is, we have to measure it. But given that finding, development, and production costs have doubled since 1999, I've got to be seriously concerned that you've understated the risk of capital cost overrun, particularly when we've seen the experience in Fort McMurray when you have very thin labor markets.

MS. KAH: That leads to the next risk, which is the price risk. And I ... only have one copy of this, but I'll show it to you. This was a forecast done of drilling rates in the late 1970s and they did their usual plus or minus 20 to 50 percent in terms of their base, high, and low cases. And this lower line is what actually happened. The problem with doing your usual ... plus or minus two standard deviations, is you miss discontinuous change. And we're talking about 45 years. ... The world can change very dramatically, think of how the world changed in the last 10 years. We had ... two decades of \$2 gas prices and the gas bubble, which had been created by an unusual combination of federal government regulation, disappeared and free market pricing looks different. But we can't even imagine the things that can happen in the next 45 years. In terms of price risk, ... the biggest risk that I'm personally worried about is coal and building coal-fired power plants. And Tony Finizza in his presentation talked about the cost in which you would build a coal-fired power plant rather use gas is about \$4 the gas price. So, my first question to Tony is why you are using \$6 as your mean, if you believe that fuel switching long term to coal takes place at \$4. And, again, looking at this graph again. The range of risk from \$4 to \$8 just isn't wide enough, both on the upside as well as the downside.

MS. KAH: But let me come to this risk of the perfect storm and the way that has been described is: what is the risk that you're going to have a cost overrun as well as be in a low price environment? And I would argue that there's a fairly good correlation that those two things can happen. And the reason why is ... we're in a production investment cycle right now. And we're probably at the top of the cycle, although some would argue this is the new world. ... there is uncertainty about that, but let's say for argument sake that the people who

believe that this is the top of the cycle are correct. Well, what happens is: prices are high. We doubled our spending as an industry in the last three years. The service industry hasn't been able to keep pace, and that's why you're seeing this hyper cost inflation. We also don't have the people to do these projects that we're talking about. And so, there's ... labor rate deflation. And so now you're building the project in an environment that already has hyper cost inflation. Just when you finish the project all of this extra spending that we've made going into all these projects, the supply response will lead to lower prices because we are at the peak of the price cycle. So, you're doing the project in a very high cost environment and the same things that caused that hyper cost inflation will be the things that cause prices to be lower in the end, the supply response that are industry is having. So, I think there is a very good chance that you could get that perfect storm. I wouldn't say very good, and I haven't measured ... but it's enough that companies like us worry about this risk and the state ... should be worried about the same risks we're worried about. You know we're in this together

CHAIR THERRIault: Mr. Van Tuyl, did she leave something for you to talk about?

MR. VAN TUYL: Actually, I think there are a few crumbs left. One of the things when we talk about risk and cost risk, it seems like ... we tend to focus on capital costs. But, by far the largest cost for this project and other mega projects isn't capital cost, it's government take. And that's why these mega projects, like BTC in the Caspian Basin, are built on the back of fiscal certainty contracts. The BTC project allowed the opening of the Caspian Basin, that created wealth, opportunity for those living in that area. That was a policy choice made by that government and the result was the project going forward, not only the BTC oil pipeline project but on the back of it the South Caucasus gas pipeline project. However, the capital cost component is also obviously significant. We ... tend to talk about the 2001/2002 study results, ... roughly a \$20 billion project. Pedro had touched on this ... that a lot has happened since that 2001/2002 study. Look what's happened with steel price; steel prices doubled since that study. The Canadian dollar exchange rate is completely different than it was ... just a few years ago, labor costs, as Marianne mentioned, are different. Mega projects, therefore, when you add up all these components have unique risk profiles, I think that's an important thing for folks to bear in mind. That's what the IPA fellow kind of measured on about these mega projects. How that

manifests itself in some of the presentation that we saw over the last couple of days, there's one example ... I'd mention is ... how the assumed tariff was characterized. A \$1.21 to move gas from the North Slope to Chicago. If anyone could actually ship our gas today, they'd step up and say we'll ship your gas from the North Slope to Chicago, be able to financially back up that promise to ship our gas, we'd be very interested in that. Or, if anyone could purchase our gas ... for the difference, that would be an interesting prospect. But in the real world ... that hasn't occurred. And I don't expect that it will and that's because the risks associated with that magnitude of a commitment are unrealistic for any sort of a third party to take, just because of the sheer magnitude of the commitment that we're talking about.

MR. VAN TUYL: And then just a bit on price risk also. Again, this was eloquently stated perhaps by Marianne, I just want to maybe draw a line under it. The price risk, we don't look at as measured by a variance around a base forecast. That, to me, is a trap. It assumes that you have a fundamental grasp, especially over a long period, on structurally what's going to happen in the marketplace. The real risk of price isn't that "Gosh, I got the base forecast wrong by plus or minus 20 percent." The real risk is something structurally changes whether it's unexpected supplies coming on, whether it's new technology introducing competition. Something structurally changes. I think Marianne's example of the rig profile - I'm not sure exactly the sequence of events that lead to the lower rig utilization, but something obviously unexpected and something significantly structural happened. And that's the real price risk. Most forecasters, I know Econ One used EIA's forecast, ... characterize that sort of a risk by coming up with completely different price scenarios. And EIA is no different, they have a whole host - I think, 14 different price cases, depending upon your view of future supplies and demand, and world economic growth and what not. So, it's important to characterize a wide range of possible outcomes, especially when you're looking at investing \$25 billion and you're looking at that payoff in decades.

CHAIR THERRIault: Roger.

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MR. MARKS: Well, at the Department of Revenue, our perspective ... was that gas prices over the next 45 years are unknowable. And ... trying to even think about what they're going to be is

an absolute ... folly. You could ... come up with a scenario where their \$2, ... \$20. Again, ... thinking about low probability events, ... you open up any history book [and] what's between the covers is ... a series of improbable events. They happen all the time, you could pick up a newspaper tomorrow, somebody has perfected nuclear fusion So, we saw ... it as unknowable. What ensues from that is that this project could turn out to be very, very good, it could turn out to be very, very bad depending on prices, depending on whether you come in on budget or not. What was important is that if the producers are willing to take the downside risk that if the upside ... materializes that the state doesn't come in and take the upside away with higher taxes. If the state were to do that ... the symmetry between taking downside risk and getting upside potential is destroyed. That's ... one significant reason why ... we made the determination that the gas is stranded because of the fiscal instability issue on your status quo.

CHAIR THERRIAULT: Roger, a question that I posed during the Centennial Hall presentations sprung from a memo that was written from Dr. Van Meurs in the fall of '04. The state was preparing to make a counter proposal across the table and ... I'm not sure if it was DNR or the Department of Revenue that had come with a mechanism to share some of the price risk. There was a calculation that was done if the price was below \$3.50, there'd be a separate payment ... made from the state to the companies and above \$3.50 there was an additional payment made from the companies to the state. Can you tell me was that actually added to the state's proposal? Did the state determine or decide to drop that mechanism away? Or, was it dropped away at the request of the producers in the negotiation? ... What was the dynamic around that counter proposal and what have you?

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MR. MARKS: Well, the ... negotiation evolved, ... lots of ideas were thrown out and explored, ... lots are discarded, some we move on with. ... Again, my memory is not that clear that far back and anyone else involved in the negotiation can pitch in. But where we ended up was an arrangement where the state and the producers are sharing downside risk and upside potential absolutely symmetrical. We're taking 20 percent of the gas and 20 percent of the cost and that's where we ended up. And ... it seemed from both sides that there was symmetry that way in terms of sharing risk. ... In terms of that particular issue, the cobwebs in my mind are just too thick to remember exactly what transpired on that issue.

CHAIR THERRIAULT: Anybody else? Dr. Van Meurs, I forwarded that question during the Centennial Hall presentation and, I'm sorry, I don't remember of the top of my head, your response at that time. I'm wondering if you have anything more to add to the discussion?

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DR. VAN MEURS: Yeah, of course I ... remember the proposal very well because I ... helped prepare it with the assistance of ... all of government. It was a very important proposal and that proposal, indeed, included what was called the PDP, the price differential payment. And that price differential payment indeed shared the risk on the downside by us ... kicking in some cash and took some cash up at the higher ... price. So, it ... threw in a touch more progressivity than ... we have now in the deal. I wouldn't want to call that an extravagance of progressivity, but there was a little bit of progressivity in ... the PDP proposal. So, that was definitely a ... part of the October proposal. As I also illustrated during my presentation, the companies also came in with their proposal. The companies felt that ... the PDP proposal was unacceptable to them. Many aspects of the agreement that they proposed was unacceptable to us, as is in any negotiation. And ... as I illustrated in my presentation during the meeting ... I think many of the features that were acceptable to us in the end were agreed ... by the oil industry. As any deal, the deal that was reached was a balance between the objectives of the parties. And does the government ... [or] the industry get everything it wants? No. But that's how deals be made. And I think, from that perspective, was there a modest progressivity feature called the PDP in the proposal? Yes, there was, but that, at a certain point in time during the negotiations - I think it was ... about in the spring of ... 2005 or close to the summer of 2005 that ... feature was traded off for another concession that the industry made. And consequently, that's ... the history of that feature.

CHAIR THERRIAULT: Econ One, any of the stuff that we discussed ... under risk and then ... Senator Wagoner has a question with regard to risk.

SENATOR WAGONER: [Inaudible.]

CHAIR THERRIAULT: Gentlemen on risk and then we'll move on to a different topic.

MR. JOHNSTON: One thing that Roger said, we didn't want to have a situation where the government could take all the upside. I want to be very careful. Nothing the state has proposed and nothing any of the consultants have every proposed has come close to taking all the upside. And to have a system that's adequately progressive is not even going to come close to taking all the upside and that's never been proposed nor even contemplated. But, what I say: we need to have a more progressive system than what's been designed so far. And on the downside, if we've designed this thing based on that PFC Energy type of data, which is just way wrong, then we've taken care of the downside pretty well for the oil companies, let me tell you because the terms aren't right. You can't design this thing, as we have, with that kind of data. And Dr. Van Meurs, I think you would have to agree, that perhaps you'd have to reconsider the design if you went back through and put in the appropriate capital costs for the LNG projects in that universe of examples where they (indisc.-coughing) the tankers and where they've ignored the re-gas facilities and things like that. And then examples like Kashagan where they're off by ... almost a third of an order of magnitude. I think we have to almost start all over if it's that bad. And I'll tell you, it's that bad.

DR. VAN MEURS: Well, Daniel, I did that and that's what I was trying to explain to you. ... As I said this is a commercially available database, it's a database that ... is the ownership of PFC Energy. In the beginning of 2005 I did correct the ... Qatar gas data. I did not precisely, as you stated, I agree with you I did not agree with the Qatar gas data. I re-did it with them. I did some other tests, some independent tests. The \$17 billion that they estimated for Kashagan - maybe it is \$24, I don't know. You are the expert on Kashagan. I don't think that none of these factors really make ... very much difference in the fact that the Alaska project remains a low rate of return project. And so consequently, I did those tests. I did review those things, I did a number of spot checks. In a number of other cases, as I said, in [Ormen Lange] ... I had a very extensive study done because [Ormen Lange] is known to be a low rate of return field. So, I wanted to ... do a detailed a study on it that was done by various consultants, ... Wood MacKenzie among others. So consequently, did I, in my mind, correct for some of the errors that are in this study: yes. Did I correct possibly for all the errors or ... different points of view on the study: probably not. But ... I don't make a judgment ... of that precise a nature. I look at the overall database, I make some connections in my mind, which I did. I agree fully with you that Gorgon was misrepresented, that ... the Qatar gas

was misrepresented, and I made, in my own mind and ... I actually recalculated ... in the spring of 2005, some of the data with ... PFC Energy. And I came to the conclusion that in the overall picture it didn't matter very much. And consequently, I ... did the work that you described ... I did a reasonable amount of error checking and ... review. I agreed with some of your observations and I, in fact, corrected for it in my own mind. The only problem is ... that it's not really my job to redo the whole database because then we would be working forever. But I ... absolutely convinced that, in my own mind with the corrections that I made and the cases that I specifically reviewed that clearly jumped out, just as you identified them, I'm satisfied that the (indisc.) conclusions in the fiscal interest finding are fine

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DR. LEITZINGER: On the subject of risk, the findings describe the project as a \$21 billion project and looked at various overrun possibilities in terms of costs around that \$21 billion figure. The findings also used a base case price of just over \$5 in 2005 terms, used a low price of \$3.75, and a high price in the \$8 range. Those numbers provide an objective basis to test the economic viability of the project and its ability to cover those risks. And on the basis of those numbers, ..., the project looks to be fine from an economic standpoint. What I'm hearing in the discussion is: "Well, in fact, \$21 billion is not the right number." In the time since then, it is now somewhat well above that; cost conditions have changed. The ... risk of cost overrun, the size of the expected cost is much higher today than is described in the findings. I'm also hearing that we ... can't know what prices to forecast; there's a risk of structural change in the economy that no one can predict. The future prices are unknowable, but then the last thing I'm hearing is: "However, ... it is important to provide these concessions to the companies in order to make the project worthwhile and have it go forward." My question is: How can you know that? Unless you're prepared ... to say here are the costs, here ... is what we expect about prices and the risk in prices and look at that on an objective basis, and ask the question how the concessions affect that. It seems to me you can't know the answer to the question whether the concessions are necessary.

CHAIR THERRIault: You've finally ... said something that's gotten Dan Dickinson to raise his hand, but it wasn't strong enough to get Exxon to weigh in. Dan and then Mr. Van Tuyl.

4:25:02 PM

DAN DICKINSON: And I guess I almost raised it before, earlier when Dr. Leitzinger made the comment. But, we do not believe that there are concessions in here. ... There have been rearrangements of some of the fiscal terms. Depending on how you evaluate them under what prices, there may be some change. I need to look very carefully and I hope to have a chance We do not believe that there are fiscal concessions per se. In terms of ... of a financial analysis, there has not been any concessions. And I believe, therefore, to ask the question of were ... those questions necessary is simply asking the wrong question. So, ... we've got to sit down and do the numbers first before we can continue that conversation. But, I hope once you've seen how we've modeled it and looked it carefully the same way we have, you'll come back and say: "Okay, that's not the right question to ask because, in fact, what we are getting under a range of prices ... is essentially the same as the status quo." We're getting two different tools, but fundamentally there's not a concession there.

MR. VAN TUYL: I wanted to make essential the same point Dan did that there aren't concessions that we view that the state made in the contract. In the fiscal interest finding in table 6, the state makes a comparison what ... revenues might have been realized by the state under the status quo had the project been able to go forward under the status quo versus revenues under the contract on the gas side and then adding in the oil. The gas numbers are essentially the same for both of those columns of numbers We actually viewed that differently. And maybe that's the nature of a negotiation that on ... most of those terms we viewed that the state was actually doing a bit better under the contract than would've been the case under the status quo. ... I know that Econ One went through several pages of analysis ... on the upstream cost allowance, on marketing risk and what not and we did the same sort of thing in negotiations with the state. We saw each one of those elements differently; we ended up where we ended up as a package deal to allow the project to go forward. We felt that the state's evaluation in table 6 is actually conservative. An example of that ... the marketing costs, ... the RIK switching, the uplift and what not. ... a short anecdote then would be to look at the MMS's experience in their royalty in-kind program where they ... got their feet wet a little bit a few years ago and then over the course of the past couple of years have expanded the RIK program. And in their last annual report, ... they say in their

executive summary: "Fiscal year 2005 saw the continuing positive evolution of the MMS RIK program as a fully operational component of MMS's absent management approach managing the nation's mineral royalty asset stream. Program performance far out paced the program goals. ... Administrative costs continued to decrease compared to the cash royalty alternative. The RIK cost less. Revenues to the treasury were increased relative to ... the cash royalty alternative. Accounting periods were closed within six months. Conflict with producers was virtually nonexistent. Agency knowledge of the nation's energy infrastructure markets was increased." In the state's analysis, they said ... that's a five-and-a-half cent marketing cost. MMS's experience has been just the opposite, that it's actually been a benefit for them marketing their own gas. And as another alternative there are aggregators that exist to provide the service to folks that don't want to market their own gas. I just looked on a web site two days ago, of a couple of aggregators in Alberta. ... Pan-Alberta, NORPAC, and [Cargill, Inc.] and all three of those offer marketing costs well below five cents So, there's plenty of options available, so we thought the state's estimate - that's one example - was ... quite conservative.

CHAIR THERRIault: Mr. McMahon and then we'll go to Roger.

4:30:07 PM

S.A. (BILL) MCMAHON JR., Commercial Manager, Alaska Gas Development, ExxonMobil Production Company : Yeah, I have to echo what Dan Dickinson has said; we view that the state has achieved the status quo as far as the financial terms here. The key enhancement that they're offering to us is this alignment of our interest through state ownership in the midstream, taking gas in kind in the upstream, and thereby allowing us to invest less in the midstream of the project.

There's four other things that are being given here as well that are important to us that have not been discussed today, because they're not financial, they're not economic. They're offering a process for timely and impartial dispute resolution. That's a very important aspect of this contract. They're sure that we have access to the Point Thompson leases, then we can go to the open season and bid with confidence that we can commit gas to that open season to leases that we will have access to.

We have the insurance that the contract will be of sufficient duration to produce Prudhoe Bay and Point Thompson and the other

new discoveries that are necessary to -- in this project. And then, finally, this does provide the predictable and durable terms that have been envisioned by the Stranded Gas Act for both oil and gas. And how do we know if this is a sufficient package? Because the three companies are ready; if this body, the legislature, enacts this ... contract, we're ready to proceed with the project. That's how we know that this package is sufficient.

CHAIR THERRIAULT: Senator Wagoner, do have a point on this topic, or are you (indisc. overlapping voices)?

[4:32:00 PM](#)

SENATOR WAGONER: Yes, yes I do. Before we go any further, you know, I look at a 35 percent credit on the TTP; I look at 20 percent state participation in the construction of a pipeline; I look at 24 point some percent -- some cents per NCF infield allowance; and then I here people here at this table say there are no concessions. And I guess is what I would like to know then is what you folks' definition of a concession is, because I surely think that those three items I just mentioned - and that's just the start of it - are concessions that the State of Alaska has made, and if they aren't, I want to know what they are. Thank you.

CHAIR THERRIAULT: Roger, you have your hand up, do you have a, maybe a wrap-up?

[4:32:47 PM](#)

MR. MARKS: Well, I'm going to make one -- ... answer Senator Wagoner's question succinctly, it's a total deal; we make payments we get money. You know, what we estimated at \$5.50 over 35 years, we get \$100 billion. That's, I mean, that's after paying ... what those payments or concessions you call. If you want to look at it as a total deal, we get a gas line, we get \$100 billion. One thing I wanted to think on -- one point I wanted to make, though, about the (indisc. - coughing) concessions is again what Dan said, you know, I don't think there are concessions in there. Again, we're getting the -- we -- what -- you know, what Pedro has often pointed out is through state ownership and through taking the gas in kind, we've managed to increase the rate of return 2 percentage points, so we've given up nothing. A new issue -- and, you know, the one thing in the issue of fiscal stability. Again, we believe - you know we talked about this two minutes ago - we believe it's

absolutely critical to the project; without it there's no gas line. Again, what's the total deal? What do you ... get off what you give? You get ... fiscal stability, we get a gas line, a hundred billion dollars; it's a total deal.

CHAIR THERRIAULT: Daniel and then Marianne.

[4:34:06 PM](#)

MR. JOHNSTON: The thing that you've given up nothing - I don't think that's quite appropriate nor fair. The 20 percent equity ownership requires that you pay 20 percent of those capital costs, whether you're on budget or go over budget. And to say that this thing is revenue neutral - that you're going to get the same revenues - that's just not fair to say that, because in the early stages, just like the oil companies, your revenues are going to be negative if you pony up your 20 percent share of the capital costs. Now I call that a concession, and I don't consider that revenue neutral, because the revenues are going to be the same, as far as what you received, proposedly, but in one case you don't have to put any money up and the other case you put up at least \$4 billion, or so. So, to say that you give up nothing ... does not work for me and I don't think it's going to work for the ordinary Alaskans either.

CHAIR THERRIAULT: Roger.

MR. MARKS: Under the status quo, we pay our 20 percent of the pipeline slowly over time through the tariff deduction, our royalties, and taxes - with interest.

CHAIR THERRIAULT: Just a quick question: The -- earlier there was a reference to MMS information. Is that all information that is available? Because I'm told that it can't be found on the website. So, okay, I just wanted to ask about that because I have not seen that information. Do we have, let's see, Marianne, I think I recognized you, and then [Dave] Van Tuyl.

MS. KAH: Comments on the Econ One economics: We were concerned because we couldn't reconcile to a lot of your numbers. In fact, I want to express disappointment that we didn't -- you didn't meet with us and, you know, go over some common assumptions on the economics. So, I would hope in the future you would be willing to get together and share information and try to come up with common economics. But the thing I think that bothered me the most was that you assumed that the project was soft in Chicago -- excuse me, at AKO in the Canadian border.

And to me that is incredible - back to the risk subject - that's incredible commercial risk dumping 4.5 million cubic feet a day of gas in the AKO border, and I doubt the Canadian government would allow me to trash their market in that fashion. So, I think the economics need to include ... capital expenditures for capacity down to the Chicago market, which of course is much deeper market and will give you better value for the gas.

The second thing I wanted to talk about is this concept of firm transportation. I had the sense that you were arguing that this project doesn't need any firm transportation commitment for the capacity. And I would like to suggest that the -- this project will not get financed - even projects, you know, a quarter of this costs don't get financed - without firm transportation capacity commitment. So, the producer, the owner of the gas, has that risk of being responsible for paying this shipper pay expenditure. And I think the reason why this is important: this is why we're so concerned about us building this pipeline, as opposed to the third-party regulated entity who would have no incentive to control the capital costs. Because they would just pass that through to the rate and the owners of the gas and the state, who left lower taxes, would end up paying more. So, I think our research is that we cannot get rid of that risk - the risk of signing up for firm shipping capacity. And therefore, we're going to be exposed to signing up for some long-term tariff, and therefore we want to have some control -- be able to control those costs. And we have the right incentives to control the costs, because we, like the state, are worried about the value of the upstream gas.

CHAIR THERRIAULT: Marianne, I think certainly the learning curve has been steep, but I think everybody in the legislature understands that certainly a project won't go forward without firm commitment for the capacity, either by some shipper or producer or somebody. So, I want to take Bill, and then Senator Wagoner's got extra questions.

MR. VAN TUYL: Dave.

CHAIR THERRIAULT: Dave, I'm sorry.

[4:37:49 PM](#)

MR. VAN TUYL: I guess, coming back to Senator Wagoner's question and back to Roger's response: One of the issues that you brought up was state participation, and one -- maybe this is counterintuitive, but the state being a participant -- well, the

state not participating, as Roger said, the state will basically reimburse that cost to the producers through the tariff over a long period of time. That tariff's a deductible cost. So, if there are cost overruns in the state, in the current status quo, we'll pay for all of those cost overruns through the tariff. The -- as a direct equity participant in the ... project, the state will actually have an opportunity to hedge some of that overrun risk, because the state will ... get an equity return on their tariff as an owner. So, it will actually hedge some of that ... cost risk. But I wouldn't characterize that as ... a concession; it's actually a new rule for the state; it actually reduces the state's risk.

On the reference to the 22.4 cents - the difference between cost allowance, I guess a couple of aspects to that: First of all, the upstream cost allowance is a lease right that is characteristic with DL-1 old-form leases. The -- there was reference made in Econ One was that, or the implication was that was a Prudhoe Bay-specific right, and it's not. In the royalty settlement agreement, we've established what the value of that right was for Prudhoe - and it was based on 22.4 cents - (coughing) excuse me - but that lease right exists for all DL-1 leases, except for those that we specifically have a settlement where that ... value was set aside, which is Milne Point not anticipated to deliver gas in the project, and some - a few points - MacIntyre leases. Overall, 90, about 90 percent - 89.6 percent I think the number is - of the known gas resource sits on those DL-1 leases.

Another element of the contract - another term that the state negotiated for that doesn't exist in the status quo - is ... an upstream gas payment. For every ... thousand cubic feet of gas that goes through an upstream facility, the producers will be making a payment to the state. So, it's just an example. Plus, all the ... payments in lieu of property tax that are paid on a volume basis - those are all escalated. Today in the status quo those figures aren't escalated. So, as Roger said this whole thing's a package; there's a whole host of different terms that move one way or the other. And I think there are, when we -- again, we could go through element by element and kind of talk about how we ... each view things like the UCA and ... those fees, but the fact of the matter is I don't believe there are specific state concessions characterized in the contract.

CHAIR THERRIault: Just a technical thing here: Dr. Van Meurs, when you're not speaking, our moderator here in the back room

puts your phone on mute so we don't get feedback. So, don't think ... that you're being cut off...

[DR. VAN MEURS]: Oh, okay.

CHAIR THERRIAULT: ...they just put you on mute temporarily, okay? Now, let's see, we have Mr. Van Tuyl and is there somebody else? Senator Wagoner.

[4:41:36 PM](#)

SENATOR WAGONER: First, Dave, it's my understanding that those ... leases you're talking about are going to be rolled into the contract; therefore, the term of those leases will be the terms of the contract at that time, not the terms of which they were written under originally. So, I don't understand how that 22.4 cents allowance is given away due to the lease terms, because my understanding in discussions I've had is those lease terms change and they become the terms that are in the fiscal contract when they're rolled in there. That's what one of our consultants said. But you know, ... ladies and gentlemen, I just want you to understand one thing. There's six of you sitting up at that table. I asked a very specific question awhile ago, and I feel like I've gotten the run-around. I'm one of 20 people on the Senate side that you've got to convince that this is a good contract. And if you refuse to answer my simple question - "What's a concession? What is a concession if some of these things I suggested are not concessions?" - then I'm having a pretty tough time buying what you're telling us.

CHAIR THERRIAULT: Will go to Dan. One thing just on the DL-1 leases: It's my understanding that in the Prudhoe Bay area that the core settlement I'm not so sure that the state has conceded that that ... particular interpretation on the DL-1 leases applies where they are. So, if in fact this contract was signed, that may be the first thing to go to arbitration, who knows. Let's see, Daniel had his hand up, and then we'll go to Dan Dickinson.

MR. JOHNSTON: When people use the terminology, "to sweeten the pot," I start smelling a concession, and that's the kind of terminology and rhetoric that we've heard a lot here in the state of Alaska in regard to this contract. Doing things to make this thing work; that has the ring and sound of concession to me.

CHAIR THERRIAULT: Dan Dickinson.

MR. DICKINSON: Senator Wagoner, I'd like to answer your question as directly as I could, and perhaps my way of doing that would be numerically to set those out. You are absolutely correct that you can look at certain areas - and let's just take the 22.4 cents, which is just a royalty deal, but under this would also apply to ... the tax gas - and you can go in and you can make arguments about under our statute what it would have been. We've had those arguments with the producers, but my ... only point would be there are some things under this contract that you can make a mechanical comparison that are lower and other ones that are higher, particularly if you look over time. And we ... will get you that documentation, and ... I guess it's unfortunate this is the ... best -- if this is the best way of looking at it that's been laid out, and we haven't laid it out as clearly, you're right, we ... do owe that to you. But I think it's important, as Roger said, you look at the whole package, and ... rather than pointing at one or two things and say the state is getting less under the circumstance under these terms without looking at the other pieces.

CHAIR THERRIault: Let's see, Barry, and then Tony earlier you were squirming in your seat, I think.

[DR. FINIZZA]: My point is long past.

CHAIR THERRIault: Okay. Barry.

[4:44:37 PM](#)

MR. PULLIAM: ... There are a couple of points I'll just [be] quick to point out. Marianne, I certainly would appreciate if you guys would share assumptions. I know ... Tony and I sat a year ago with a group of folks who are producers, after we had reviewed all the administration's models and looked at the assumptions, and talked with that group, and there was a request at the top to get the assumptions that you guys were using. I don't think we ever got that. So, I don't think it's fair to say -- I think there was history there that maybe you're not familiar with. Second, we talked about the UCA a little bit and how they apply, and the numbers there. The numbers that we have in our ... model are not different than what the administration has used in their assumptions. Maybe there is some legal question there.

CHAIR THERRIault: Speak into the microphone a little more.

MR. PULLIAM: Maybe there's some question, but the numbers that we've used are not different than ... any of the models in the fiscal interest findings and, in fact, the majority of the impact, I think, that you have there in the UCA had to do with tax gas and not the royalty gas, because Prudhoe Bay is going to be the same regardless. It's just the inflation rate that it's applied to.

CHAIR THERRIault: Tony.

[4:46:00 PM](#)

DR. FINIZZA: I know have a new idea.

CHAIR THERRIault: Good thing you got in line awhile ago there.

DR. FINIZZA: I'd like to proposed that you set up a model round table of Econ One producers, DNR, Roger Marks, Dan Dickinson to take place some time in the next two months where we can weigh these things up.

CHAIR THERRIault: Well, I certainly have heard from legislators that they like this type of discussion; it helps ... to see where there's agreement and ... where there's ... disagreement on the policy call. And so, I would like to do more of this. ... There was a bit of criticism of not getting together to share information before presentation, and I have to let you know, I pushed these gentlemen hard; they were finishing up their presentations and my staff was at Kinko's at two in the morning. So, I don't know that we could have had it earlier. But it's always my preference to try and have that discussion ahead of time, if possible. I'd rather not spend time talking about stuff where there's -- ... if it's just based on a misunderstanding. Daniel.

MR. JOHNSTON: Oh, by the way Tony, I'm glad that I wasn't invited to that party. And, Dr. Van Meurs do I understand, then, that you're going to provide the ... background information on the PFC Energy reports so that we can verify those numbers and see why I would make some of the claims that I've made?

DR. VAN MEURS: These reports are already available. I mean, the reports that were done in 2000 - I think 2004, 2005 - all of that material is already available.

MR. JOHNSTON: But I don't think there's any availability as to the underlying assumption that go into those numbers.

DR. VAN MEURS: Oh, no, no, no, the database for each project, no. That is a database of ... PFC Energy.

MR. JOHNSTON: But you can get the ... results just as we did; and we did get some more information. But I don't think there is any availability of the detailed assumptions underlying these.

DR. VAN MEURS: No, no, no, as I explained, we verified a number of items and we also disagreed to some of the things that Daniel disagreed with, and consequently we reworked a number of those items. And whatever really worked - that information is available.

MR. JOHNSTON: Okay, I guess the answer's no.

CHAIR THERRIAULT: Well we certainly -- if the numbers were cleaned up or adjusted for, we do want to get that information.

MR. JOHNSTON: I look at a handful of these with which I'm fairly intimate and I know that they're just dreadfully wrong, and it's absolutely clear to me that many of the LNG projects - even now with the fixes that you described - don't include such things as tankers, and we know that's a huge part of the cost associated with these things. Kashagan is so far off that when we fixed that, I'll bet that the internal rate of return for that is lower than what we're contemplating here in Alaska, in which case, how do we justify sweetening the pot in the way that we have? There's so much writing on this I think we deserve some of the base data and better information on the assumptions that they use.

[4:49:39 PM](#)

CHAIR THERRIAULT: Okay, do any of the legislators have a new topic, in particular on the information that was presented - the fiscal information, fiscal evaluation? How about any other topic? Okay, I've got one. I started asking some questions and spent a little time at [the Alaska Oil and Gas Conservation Commission (AOGCC)] talking about the ... - and this was a question that I posed last week in Juneau, but the meeting had to wrap up and I'm not sure that I got the answer or information I was looking for - ... what AOGCC has indicated to me that Exxon as a company always talked about production, the time

frame was the year 2017. This project is particularly supposed to be producing gas 2014-2015. If we're entering into ... building a mega project [with] that long leave time, construction time, it looks like we're getting close to the point where in order to take gas off the ... gas cap and get it market, we're there or we're there soon.

CHAIR THERRIAULT: So, the question that I had posed at the Centennial Hall briefings was that, had we reached the point where if a project was not developed, that value to the state would be destroyed. And the response that I got back was, "Well, it looks like 2014, 2015 [is] probably the point where the state would be able to show conclusively that value was starting to be lost." Then I asked a follow-up question about, "Well, where as your answer's specific to the value to the state, what about value to the company?" Because it's a tremendous companies, and at what point does the recycling eat up more value that what you get out in oil molecules? And I know there's a price component to that. But I'm just looking to see - you know, not only for the state's interest, but the companies' interest - at what point do you need to start taking some of that gas off and get it to market? What's your motivation right now, or how close are we to your company's being motivated to make sure that you get maximum preservation and production and value for your shareholders - and is it 2014, 2015? Go ahead, Mr. [McMahon]

[4:51:54 PM](#)

MR. MCMAHON: I guess the ... history of Prudhoe Bay is that when it was first discovered, ... gas sales were first forecast to begin in 1984 and, as was demonstrated in one of the charts from Econ One, if you have investment opportunity, and you have your choice between doing it now and doing it at some point in the future, they might have the same rate of return, but they will have a lower present value. So, to maximize a profit to our shareholders, ... we need to get the gas flowing as soon as possible. Further delay does destroy value.

CHAIR THERRIAULT: Okay, and it was suggested to me that because the companies had not made continuing investments in gas handling and perhaps you're running your own internal economics, you realized that you can reach the point where the increased investment for just cycling the gas didn't pay off long term, and so you were reaching the point, I guess that ... backed up what you just said that it's time to get the project going

because if you don't the value to the state ends, and to yourselves you run the risk of destroying part of that value.

MR. MCMAHON: Well, you know as far as gas handling, those investments are justified based on the incremental recovery of oil and natural gas liquid. You know, we made gas handling expansions in the past; we've not been able to justify any here recently. My comments were relative to gas sales.

CHAIR THERRIAULT: Mr. Van Tuyl.

MR. VAN TUYL: Yeah, I don't know that we look ... specifically at what point would we lose value if we continued cycling, but I would agree that we're motivated, not just in Alaska, but around the globe, to develop resources. That's what we do; that's what our shareholders pay us to do, to develop resources. And the key is, with a project like this, where you have a source of stranded gas supply, is to be able to match up the capital required to unstrand the gas with the market that you're going to be delivering that gas to. It's a ... pretty daunting challenge. We're very motivated to develop that gas as soon as we can; that's why we submitted an application in January 2004; that's why we've negotiated this fiscal contract over the past two-plus years; and that's why, like Bill mentioned, if the legislature ratified the contract and the governor signs it, we're going to sign it and we'll be developing that project. That's what we want to do. As far as a break over point, and what-not, ... I think that's a theoretical calculation and virtually unknowable, because it depends on - like you pointed out - what the price of gas is going to be, what the price of oil is going to be, what the relative value of continued [miscible] injectant is versus gas down the pipeline - all those things. But, at the end of the day, ... our motivation is to develop resources - period.

[4:55:26 PM](#)

CHAIR THERRIAULT: And just a ... little side question Mr. [McMahon] ..., can you tell me, under your current plan, is Point Thompson - because it's so critical to the overall economics of a gas pipeline - is it proposed ... to be developed as a gas field or a well or liquids field? What's the current plan?

MR. MCMAHON: Yeah, I guess I'm not familiar with the AOGCC definitions on oil field versus gas field, so I'm not qualified to respond to that.

CHAIR THERRIAULT: Marianne, you have comment?

MS. KAH: Oh, I just wanted to comment that ConocoPhillips [Alaska, Inc.], as you probably already know, is champing at the bit. We're ready to go; we want to start this pipeline. But I just want to caution people that we have to do front-end engineering very carefully; we shouldn't rush the schedule and make the same mistakes that were made involving the TAPS pipeline in the ... 80s. We ... should learn that lesson and not rush, and do things very carefully in terms of upfront planning.

CHAIR THERRIAULT: Representative Samuels.

REPRESENTATIVE SAMUELS: I've got a new topic, and I guess it's only directed at Daniel and at Econ One, because I pretty much know what everybody else knows about it. There's going to be a ... ballot initiative on a reserves tax, and generally what it does is it'll take tax resource in the ground - take about a billion a year until the project starts making money, and then you reduce your taxes from there on out. And I'm just wondering, I guess for Daniel, on a global perspective, is this done anywhere else? And then on an economic perspective, what does it do to the metrics?

MR. JOHNSTON: Representative Samuels, you're correct; on a global scale it's extremely rare. I would be fairly hard pressed to come up with similar examples. And, as far as the economics are concerned, it's going to hurt the economics, there's no doubt. [It] depends on how it's structured, and I guess there is some room for, or it's contemplated a reimbursement of some sort, too, and I haven't really looked at how that relates. The word has been - and like you I know what the others think of it - that it reduces the economics, and folks talk, there's no doubt about that. But then there are others, too, who believe, and I don't blame them, that it might provide some added incentive to make this thing happen; something I haven't explored very much.

DR. LEITZINGER: I would start, I think, with the last thing that Daniel said. I think the most important feature of a reserves tax is the incentive effect that it creates. If you are going to do the project at all, to do it sooner rather than later. There is a secondary question, which is: If ... for some reason it can't be done sooner, and therefore part of the project means incurring the reserve taxes, would the companies

at that point simply decide to walk away from it? And I haven't run those kinds of economics; it seems to me to be a fairly far-fetched proposition.

CHAIR THERRIault: What would be a far-fetched proposition?

DR. LEITZINGER: The proposition that in the face of the reserve tax, if you knew you couldn't start right away, and thereby avoid the effects of the reserve tax, that you would simply walk away from the reserve.

REPRESENTATIVE SAMUELS: Representative Crawford can correct me, the reserves tax will start on January 1 of next year.

REPRESENTATIVE HARRY CRAWFORD, Alaska State Legislature: Starts -- ... that's the effective date?

REPRESENTATIVE SAMUELS: Right. Representative Crawford, go ahead.

REPRESENTATIVE CRAWFORD: If it were a producer owned and built pipeline, it might effect the economics of that pipeline, but if it were an independently built and owned pipeline, how would it affect the economics of that? Would it cost any more in steel or labor, or any other aspect of building the pipeline that you can imagine?

UNIDENTIFIED SPEAKER: Representative Crawford, I detect you looking at me in particular, and no, I don't care who built that pipeline, the cost of steel is basically the cost of steel. I know it can make a difference, some buyers have better financial strength and creditworthiness and they can get the steel maybe a little bit less expensively than others. But basically, no, the cost of labor and cost of steel is largely independent of who builds it, in my opinion. But by the way, though, it's something that I haven't given a considerable amount of thought to. But that's my initial impulse.

REPRESENTATIVE CRAWFORD: Thank you.

[Further comment, possibly by Vice Chair Samuels, is indiscernible due to the next unidentified speaker speaking simultaneously and louder.]

[5:00:07 PM](#)

UNIDENTIFIED SPEAKER: ... Well you said you knew how the rest of the folks felt about the reserves tax. I would offer about my opinion, but if you know what we think already, I won't. But ... are you interested?

REPRESENTATIVE SAMUELS: I've heard the administration speak and I've heard the industry speak. I can -- If you'd like to throw two cents in, feel free though.

UNIDENTIFIED SPEAKER: Well, it's a -- you know, one can make a pretty good case that the idea of commercializing the gas didn't even begin to make sense until 2000, when prices in the Lower 48 went up. One could also make a pretty good case that since 2000, the producers have been working very hard to begin the commercialization process, mainly getting the government framework in place, which is, you know: What are the rules? Before we move forward, we have to know what the rules are. ... They did ... the conceptual engineering study; they've gone to Congress; they got their enabling legislation; they've gone to Congress to get tax breaks; it was the first to get regulations in place; they got the Stranded Gas Act renewed; they got a Stranded Gas Act application; [and] they negotiated a Stranded Gas Act contract. Given that, the way the reserves tax works, if they guaranteed 100 percent, "We're going to build the pipeline and have a thawing in 2016," they still pay the reserves tax. They would pay the reserves tax while they're laying pipe. The mechanism for recovering it through the credit mechanism is -- you know, I've run numbers, you might recover maybe 40 percent of it and your recovery is extremely black and loaded. You know, the Department of Revenue believes the reserves tax is extremely unfair, it's punishing people for a crime they didn't commit or a crime that wasn't even committed, and would create a Draconian investment climate in the state. I'll stop there.

CHAIR THERRIAULT: Representative Seaton, is this a new topic?

REPRESENTATIVE PAUL SEATON, Alaska State Legislature: Yes.

CHAIR THERRIAULT: Okay, go ahead.

[5:02:18 PM](#)

REPRESENTATIVE SEATON: Back just a little bit to -- one of the comments was made about trying to increase the internal rate of return and taking in-kind to do that. And I guess my question becomes -- is that -- you know, we generate a lot of problems by

taking it in-kind, whether it's upstream costs, whether it's ... participation here or there. But it seems like what we're doing is - I think Roger said it pretty well - is that it gives it some really stability for problems that might occur within the system. But I guess my question is: ... what if those don't occur, haven't we just given away a whole lot ... into this contract, instead of having them contingent upon some of those things happening? I mean, we're structuring this whole thing around increasing internal rate of return for the likelihood of something might happening, but if it doesn't, it seems like the state's a lot worse off in the fiscal long-term picture.

UNIDENTIFIED SPEAKER: So, let me paraphrase the question. You're saying, "What if we do all this and the pipeline's not built - are we worse off?" Is that the question? Or, "If the pipeline is built are we worse off?"

REPRESENTATIVE SEATON: Yeah, I guess what I'm trying to get at is that ... we're structuring this in-kind deal and we're structuring a lot of this ... to increase an internal rate of return, because it's necessary to get the pipeline going because of the ... possible risk in the pipeline. But it seems like what we're doing is taking a lot of risk onto the state itself and lower economics in the long run if that risk doesn't materialize, I mean, if things go well, there's no balance to the risk we're absorbing for whether ... that risk materializes in construction or not.

UNIDENTIFIED SPEAKER: Early on in the process of putting together the contract we had a series of investment bank firms come through - ... I think there were a handful of them, there was City Corp, there was Merrill Lynch, there was Goldman Sax - and ... the idea was we decided the state has to assume more risk to get this project done. ... It's not something you can prove, but it's something that seems ... plausible. And we had a series of them come through, and this is sort of where this whole idea of taking the gas in-kind and ownership came up. At the end of the day, ... we said, in terms of money, ... if everything goes right, we've given up nothing, we get the same amount of money, and if everything goes right, we have a splendid project and the state's making lots of money. Are we incurring additional risk? Yes we are, but we thought that was what was necessary to ... make the project more feasible and happen, and at the end of the day ... you get a gas line, can you prove ... if we didn't do that the gas line would go forward? No, you can't. It just seems plausible that, by ... risk shifting, ... the project becomes more feasible.

CHAIR THERRIAULT: Marianne.

5:05:43 PM

MS. KAH: Yeah, I would also like to comment that I don't know that it's in the state's interest to agree to give more compensation or incentive to companies in a down price environment if things went bad, because the state would be having revenue issues at the same time. So, the best way the state can probably help that's consistent with its own interest is to improve the whole thing slightly, rather than trying to offer downside risk at the very time that the state was least able to do so.

CHAIR THERRIAULT: Roger, you ... said risk shifting. One of the things that ... I've heard from ... a number of my constituents is that it appears, although there's the pitch that it is as good as the status quo, but it seems like in achieving the status quo in revenue to the state, the state has taken on more risk. And generally, the population understands: more risk [equals] higher return. So, if in fact we took on more risk, shouldn't we have beat and exceeded the status quo?

UNIDENTIFIED SPEAKER: ... under the status quo, if the risks were too great for the producers to move forward, what do we get? The status quo is no pipeline. I mean, that came up hundreds of times in negotiation; we talked about what is the status quo. By risk shifting we get a pipeline, and again, there is a detailed discussion of risk, the fiscal interest finding - the risks are not horrible.

CHAIR THERRIAULT: Okay, but then I think, again, [at] constituent meetings the constituent then jumps to, "Well, why isn't there the ability of, you know, like an independent party?" And then we've heard, "Well, we're not going to underwrite through the [FT] commitments and the independent pipe and have that economic leakage through the tariff in the operation of the transportation system through some other company." But yet, you don't really have to take on that -- or the companies don't have to take on the FT commitments if they want to sell at the ... inlet of the pipe. They chose not to. But, Mr. Van Tuyl, you did indicate in one of your earlier comments that if somebody wants to offer or you don't believe that you've got offers to date to purchase at a price that you would sell at, so that you could ... divest yourself of that risk.

MR. VAN TUYL: Right, I mean, the fact of the matter is no independent pipeliner or other party has come forward to advance the project like that, to be able to make a plausible offer to ship gas or to buy gas with the financial backing to make good on that sort of ... an obligation. Typically parties express their willingness to advance each project by holding an open season; that's the process in the U.S. that's adjudicated by FERC that brings ... buyers and sellers and markets together. If someone wanted to do an advanced project, they could do that. Nothing in the world prevents any parties from holding an open season. Typically, a pipeline, whether it's independent, whether it's formed by affiliates of producers in the state, or however, typically, at that open season, the pipeline company would ask the producer to underwrite the project risk by signing what's called a president agreement - like planning a long-term lease. "We're going to build this pipe, but we're going to lease you the space in the pipe. And so, we're going to ask you to commit ... a certain piece of that pipe for 20 years, 30 years, whatever it is." And regardless of whether you actually ship gas in that space of the pipe or not. That's a substantial commitment. And because of the substance of the commitment -- I mean, it's tantamount to the cost of building the project. Because of the size of the commitment, a) it's difficult for the producer to make that commitment without knowing what the rules are for the period of the time that's necessary to monetize the investment, and it's also difficult for a less capitalized firm to make that kind of commitment without a piece of paper that says someone's going to pay me for building -- is actually occupy the space of the pipeline that I'm going to build. It would be like building a high-rise apartment, but I don't have any tenants, but I hope they're going to come. ... Typically, third party would get a transportation agreement from ... a shipper. I guess, to [close] -- and that hasn't happened yet; no party has come forward to hold an open season and to enable that to happen. We would ... plan to do that, as outlined in the project summary, dated May 10, on the back of the fiscal contract, which gives us the certainty that we would need to enter into that kind of commitment. And it would be notionally two years after the effective date. Lastly, I guess I'd say the fiscal contract certainly doesn't preclude third-party ownership - it actually enables it, because it enables the project to go forward. And I know BP has always said, "We would welcome the participation of any party that was willing to take on risk, pay their bills, and add value to the project."

[5:11:32 PM](#)

CHAIR THERRIAULT: [To] clarify "third-party ownership": just participation in the line, or potential, eventual divestiture of the line to the third party?

MR. VAN TUYL: I guess I'm not sure I understand the difference, but it would be having a party other than the four parties represented here be involved in the project.

CHAIR THERRIAULT: If there's the potential for ultimately, like pipeline that we've built in the Lower 48 eventually they spun off to third-party ownership, should the state be concerned that ... a lot of the incentives were spread throughout the system, that we're not necessarily attached to the transportation system itself, and so you then spin off the transportation system and the incentives don't go along with it.

MR. VAN TUYL: Well, the way the contract works: If ... a party is added to the contract, whether it's an entity or whatnot, the entity would take on those obligations that the entity didn't perform, the obligation would still reside with the ... original signatories.

CHAIR THERRIAULT: That's another point I wanted to make, and it just evaporated. Any legislators have new topics? Representative [Meyer].

[5:12:54 PM](#)

REPRESENTATIVE MEYER: Thank you. This really isn't a new topic, but I've been -- it's a topic we've talked about a lot today and I still haven't come to any conclusion and I'm hoping that with all these consultants here that they can help me. And so, my question would be primary to Mr. Johnston and Econ One. We've been talking a lot about the equity share and what is the right amount that the state should own. I've heard that 20 percent is, perhaps, too risky, and I've also heard that ... -- I think Mr. Johnston referred to it as a concession that we don't need to make. I also heard Econ One, yesterday, say that this pipeline is one of the best projects going worldwide right now - the economics look very good on it. So, based on that, I'm thinking, "Well, maybe we should own 30, 40, 50 percent." I've heard others say that ... even 20 percent of the gap is a lot of gap. Especially, I think somebody said that this project's going to be 6 percent of the gas worldwide, so 20 percent of that is going to be a lot. And is it fair for us now to be selling this gas out in the market and not having paid the

federal taxes that the private industry has to. So, I'm ... wrestling here in my mind: What is the right equity share that we should have in this, if any. Or maybe ... we should have more than 20 percent.

CHAIR THERRIAULT: I think the information yesterday was that the line will potentially deliver 6 or 7 percent of the U.S. consumption.

REPRESENTATIVE MEYER: Okay, sorry, U.S. But it's still a large amount.

CHAIR THERRIAULT: Answer from individuals? Daniel.

MR. JOHNSTON: I haven't said whether or not it's too much or too little, and frankly I'm not too bothered by the state having a 20 percent working interest, if you want to call it a working interest - and you might as well, or think of it as an equity interest. But I think that you paid an awful lot for that, because it correlates to the royalties and severance that you essentially gave up. And we keep talking here about how you need to know in the future and have the kind of certainty that you need to know, but your company - Kashagan - does not have that kind of certainty, and yet you keep increasing your working interest; you preempt it every time you have a chance and exercise your right to first refusal every time somebody tries to sell an interest in Kashagan, Conoco Phillips, without any clue as to what those terms are going to be like 10 years from now, let's face it, keeps buying additional interest. So, the price that the State of Alaska paid for that 20 percent equity interest is basically the royalty and the severance tax that you gave up, and I think that's a bit rich. And I consider that, essentially, a concession. And Dr. Van Meurs said that, "Well, you're only participating in the midstream," but if I understand it correctly, you're providing a 20 percent credit, so capital costs for upstream work beyond the pipeline, the companies can tax deduct their costs, but they can also get a 20 percent credit too. Well, that correlates to the 20 percent interest that the State of Alaska holds, so that the State of Alaska actually is participating for this in the upstream costs, as well. So, it's identical in my mind to Azerbaijan and what's taking place there. So, the only objection I have to the 20 percent interest that the State of Alaska is taking upon themselves is the high cost that you'll pay for it - one, and two is the inconsistency in treatment of this participation of 20 percent. We treat Azerbaijan one way; we treat Alaska

another way. I say let's get consistent, and then things look a lot different.

CHAIR THERRIault: Dr. Leitzinger, and then we've got Mr. [McMahon].

[5:16:29 PM](#)

DR. LEITZINGER: So far, in the discussion that's gone back and forth and in our analysis I do not yet see the case for the conclusion that state ownership in the pipeline is necessary to make this project happen now, to make this project happen at all, to make it happen one, two years from now. I see that as a big missing piece in the story. Consequently, when I think about your question, it really comes down to: Does the state independently want to be in the pipeline business? The expected rate of return on a pipeline is 13 percent on equity; there's evidence in the findings that say that you're making 8 percent on the permanent fund. There's the potential that it could earn some additional return on that money. You'd have to think about the risk that go with being in the pipeline business, and that seems to me to be really independently ... an investment decision.

REPRESENTATIVE MEYER: If I may, if I understand the probabilities and the statistics that you gave us yesterday that the risks seem to be pretty minimal on this project. So, based on that, are you saying then that perhaps we should look at more of an equity share in this and assuming that we do get the 13 percent versus the 8 percent in the permanent fund.

DR. LEITZINGER: Let me ... -- risk was used in a lot of different ways yesterday. We talked about the risk, and this was in Dr. Finizza's testimony about the perfect storm - the combination of bad events that would cause the project to be upside down from an economic standpoint. And I think, yes, it is his conclusion that that risk is low. There is most certainly, in a broader context - and it's been discussed here today - risks associated with prices, where they're going to be 30 years from now. There's some risks associated with costs, what those are going to turn out to be. In -- and that's a risk that's part of the energy development business; that's a risk that's reflected in 8, 9 percent weighted average cost of capital for these companies. I think when we put a 10 percent discount on that risk, which adds a significant added component, I think you have a good way to think about that financially. And so, the question comes down if you -- you know you can run

the numbers as Mr. Pulliam would be happy to do. Yet, ... you can take those consequences, you can put 10 percent discount rates on them, and look at what the means, in terms of present value. And then it's just a question of what the state -- where it wants to have this portfolio, as I think about it.

MR. JOHNSTON: Representative [Meyer], there's one other aspect. The risk to the State of Alaska in regard to the equity ownership are greater than the risks to the others for a variety of reasons, in my opinion, one of which is: The producers are in a better position to divert by some of that risk through portfolio management. They have investments in other places, there's no doubt about that. The State of Alaska doesn't have quite the same opportunity to do that, although they do have, through the permanent fund, some investments in other places, no doubt. And so, there's that aspect. Now, as far as the producer's risk in this pipeline, in my opinion, by world standards and comparing it to so many other places, it's extremely low. And when we talk about the risk, we talk about uncertainty in regard to what kind of rate of return you might get; we don't ever, hardly ever, contemplate catastrophic like we might - could easily - consider for Nigeria or Equatorial Guinea - and also Kazakhstan, let's face it, and Azerbaijan, too. Good grief, those places are a lot more risky and they carry the kind of risk that could be viewed as the potential for catastrophic failure, just outright nationalization or more insurrection or something like that. Much less likely here. And so, in the context of risk worldwide from the producer's point of view, this is like heaven, and I don't think it's fair to characterize them as being so terribly risky, unless we stand back and say, "Well, wait a minute, what are the other risks and what are the other places where these people have opportunities to put their money?"

CHAIR THERRIAULT: Ken was in Valdez on Friday, and he can tell you that the citizens can get a little riled up (indisc. -- laughing). Yeah, I think I saw Mr. [McMahon] and then Marianne.

[5:20:47 PM](#)

MR. MCMAHON: Daniel, let me reinforce what Pedro had said about this whole idea of state investment and what they're buying. The state investment is in the midstream, and they're buying the rights to receive tariff income in the future. It's a self-contained investment decision, as Econ One has modeled. The state's right to take royalty in kind in tax gas, those rights are held under the lease agreement and under the current

production tax statute. The state has to pay nothing to -- I mean those rights are a right that they already hold, and so there's no buy-in cost associated with that. You know, today the state exercises royalty in value, royalty in kind switching on oil. They do not have to invest in the upstream for that right. That's something that's held in the lease agreement. And so, royalty in kind for gas, tax gas, those are bona fide state take, or government take. I guess you'd mentioned this investment credit associated with the PPT, and we've had a negotiation on ... the PPT and its application to oil in this contract. And, as part of the give and take in that one negotiation, in an effort to get an agreement on a 20 percent tax break, one of the features in that is an investment tax credit. And that credit is color blind as far as whether the investment was for gas purposes or oil purposes If a producer makes an investment, he gets it credited against the PPT, and that was just part of the trade associated with doubling the oil production tax, because that's what the PPT that's being proposed for 20 percent does, relative to the status quo.

CHAIR THERRIault: Marianne.

MS. KAH: Yes, one advantage of ownership in the pipeline is I view it as a price risk mitigation - it's a hedge, basically - because it's a guaranteed return. Yes, it may be a lower return, but it's a guaranteed return, so if things go really bad and you're still contracted with a firm transportation commitment payment, you still will be able to make this guaranteed return on the pipeline, and maybe the state ought to look at it the same way, in terms of risk mitigation.

CHAIR THERRIault: Representative Meyer, did you have a follow-up?

REPRESENTATIVE MEYER: No, I guess 20 percent's a good number; I didn't hear anything higher or anything lower, so thank you.

CHAIR THERRIault: Go to Roger and then...

MR. MARKS: To answer your question, "Now, why 20 percent," it's because the state has 20 percent of the gas. If we took more ownership than we had gas, than the producers would have to make an additional FT commitment to what? If we have less ownership than we had gas, we would have to make an FT commitment to the owners which is financially the same as ownership. Now, why ownership at all? We're taking our gas in kind, we would have

to make an FT commitment for our in kind gas, but we would lose out by making an FT commitment without ownership. What we lose out is the pipeline income we would earn and, again, that ... seat of the table will get with pipeline ownership - you know, making decisions and knowing what's going on. So, that's why 20; ... it's because how much gas we have.

[5:24:25 PM](#)

CHAIR THERRIAULT: It was pitched to me that if you have to make an FT commitment to ... one of your business partners, that's economic leakage, and the company's [HCA] economic leakage, that -- and that's one of those things that ... there's alliance between the state and the company. ... Our capacity perfectly matches up with our ... share of the gas, so if we ship our gas, we don't leak any value to any of our partners. And their percentages match up with their capacity; they don't leak any value to their partners either. Barry, did you have a comment on that?

MR. PULLIAM: It's close to 20 percent; it's not quite. I mean, I think if you looked at over the time we're talking about here, the projections are more like about 16 percent, or so. So there is -- the state's not going to have as much gas. The projections as to what the state's share are at 20 percent: it's higher at the beginning and it drops over time.

CHAIR THERRIAULT: Representative Ramras, are you ready with your question?

REPRESENTATIVE JAY RAMRAS, Alaska State Legislature: Good afternoon gentlemen, Dr. Kah, pardon me if my question's redundant. Representative Kerttula told me it's not, but I was absent for awhile. All day I've been staring at the "Buy Alaska" sign on the door here. And so, the question that I have is: Why are we forming through the various LLC entities that are being contemplated as a Delaware LLC instead of as an Alaskan LLC. I'm not sure who to propose the question to or ... maybe somebody can go through how we arrived at that since the contract was negotiated.

CHAIR THERRIAULT: We did ... have ... a fair amount of discussion on that last week in committee, but I know the House members were not all able to be there, so why don't we go back over some of that explanation. Mr. Van Tuyl.

MR. VAN TUYL: Thank you Senator Therriault, Representative Ramras. There's a couple of reasons why a Delaware LLC was arrived upon. One is that, basically, Delaware has the largest body of case law in the U.S. for LLCs. One of the things that does is it creates certainty of the rules of ... how an LLC's going to operate. So, that provides that ... this is the same theme that you've heard about the clear, stable regime ...; that's a way of establishing that, because people know ... what the case law is. There's thousands of cites ... on various topics that have been adjudicated in Delaware. That's also something that's a certainty that a lender will look at as well; a lender who is going to be providing a loan to an LLC for building a pipeline also wants to have certainty and know what the rules are. That would actually enable the LLC to get better ... terms. So, certainty is a good thing for the participants, because they know what the rules are; it's also a good thing for lenders, because it might actually avail the participants to lower-cost finance. Another aspect of the Delaware LLC is that within a Delaware LLC, each member is beholden only to the interest of its parent owner. It doesn't have a fiduciary responsibility to the LLC as a whole. In an Alaskan LLC, each member has a fiduciary responsibility obviously to its parent, but also to the LLC. So, if the LLC - an Alaskan LLC - was to take position counter to the preference of a specific member, that specific member entity couldn't externally take a position counter to the LLC. So, the Delaware LLC we also saw as preserving rights to the members, and that was ... actually viewed ... as an important aspect by the state - actually by all of us, but particularly by the state - in preserving its power before FERC. Because ... for whatever reason, the LLC took the position that the Alaska member thought, "Gosh, ... that wouldn't be what I would have chosen on a tariff matter," or whatnot. Delaware LLC structure would enable the Alaska member to go before FERC and argue a position than that taken by the LLC. And in an Alaska LLC, that opportunity would not be made available. That's a couple of, I guess, the key thoughts that went into it - my understanding.

CHAIR THERRIAULT: Any other response to that? Thank you for your question Representative Ramras, my...

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REPRESENTATIVE RAMRAS: Mr. Chairman?

CHAIR THERRIAULT: Go ahead.

REPRESENTATIVE RAMRAS: I actually would enjoy having some other responses to that question and hear what the state rationale was just for the record, if it's an identical rationale, because I'm not as concerned about the creditworthiness of the member entities - BP, Conoco, Exxon - and I do appreciate the ... court challenge concern, but I would be appreciative of hearing some of the rationale.

CHAIR THERRIAULT: Mr. Griffin, and in your response, if you could just clarify in my mind if it isn't ... Delaware LLC law, is it adjudicated in Alaska state courts, or is it adjudicated in Delaware?

MR. GRIFFIN: In answering these, I'm going to have to answer with what I think I understand and what I think I've heard. The answer to the question of adjudication is no, it ... will not be adjudicated in Alaska court is my understanding. And the -- you've got the wrong state representatives here to talk about the issue; we need to get some of the legal folks here, or get them to sit down with you and talk through that. My understanding is that one of the big issues for us was the ability to ... lobby for expansions, to take positions favorable to the state before FERC - all of these sorts of issues made the Delaware LLC law preferable in the instance of the pipeline. So, that's where we wound up there. And frankly, as I remember it, this Delaware versus Alaska started out in the negotiations as ... being poles apart, and then, as we figured out what our law was like and what the Delaware law was like, the state began to realize, "Maybe we need to rethink this." So, beyond that, all I can say is that ... my understanding of this situation is very similar to what ... Mr. Van Tuyl just recounted to you. And we need to get some of the ... state's legal representation to sit down with you and give you a whole lot better answer to the question than I think any of the three of us are able to do right now.

REPRESENTATIVE RAMRAS: Thank you, Mr. Chair.

[5:32:10 PM](#)

CHAIR THERRIAULT: Thanks for the question. My feelings were particularly hurt. The LLC law in the State of Alaska was one of the first bills I introduced, and it was built around a model piece of legislation, and it appears that it has too much protection for minority orders. Do I have other questions? Senator Wagoner.

SENATOR THOMAS WAGONER, Alaska State Legislature: Yeah, I don't know who to direct this to, maybe Mr. McMahon or -- is it McMahon [or] McCann?

MR. MCMAHON: McMahon.

SENATOR WAGONER: McMahon or one of the other oil company representatives. But I've talked to people about the leases that are currently in effect on the slope, and I have no problem either having the State of Alaska have approximately 20 percent of this line as an investment - I think it's good investment on our behalf, and it helps the project that much better. But I need somebody to explain to me why it's good for the state, instead of allowing the companies that produce the gas to produce and sell that gas for us versus the way we're going establishing an LLC to basically market our gas, because I believe the terms of contract say, "If you sell that gas for us, we get the higher of value of the gas that's sold or the contract it's sold under, and I don't believe there's a charge back to the state for your doing that, because you're selling that gas at the same time that you're selling the other gas you're producing. So, where's the advantage -- what is the state gaining by taking the PILT and taking the royalty? Where's our advantage at? To me, as a business person, I would not do that when I already have somebody that's going to market my gas for me and send me a check each month. That seems to be in the state's interest. From the conservative point of view, I think that's a much better position to be in than us trying to market the gas, because there's a lot of pitfalls sometimes, especially when we only have a single source of gas to market. So, help me with that.

[5:34:24 PM](#)

UNIDENTIFIED SPEAKER: Well, I guess ... of the things that we were trying to address as we entered this negotiation is: over the years that oil has been produced we have had a lot of litigation, a lot of disputes over things like "higher of," "full consideration". And so, as we embark in this negotiation, we wanted to come up with a system where there would be less disputes, fewer disputes, and the idea came up about state gas in kind and tax gas. It solves several problems at the same time. It removes the whole ... potential for valuation dispute, because the value the state would get from their gas is those contracts the state enter. And by taking gas in-kind, you know, that did open the door to state ownership in the midstream and to a lot of things that rolled ... into that. Yes, there are

costs associated with establishing a state gas marketing organization, and ... in the financial interest findings there's an assessment of those costs. ... Some at this table have indicated that those costs may actually be lower than estimated. But we think there's advantages for the state in marketing its own gas. You can set your gas up in a portfolio that ... matches your risk tolerance - the financial objectives you want to obtain. Do you want to ... sell on long-term contracts or short-term contracts? Do you want to index your price off of spot market? Or do you want to sell linked to crude oil prices? Do you want to direct your sales to instate sources? Do you want to try and market your gas in Canada or the Lower 48? And so, all those options are now available to the state to build a portfolio that matches your desired financial objectives.

SENATOR WAGONER: And would say they're available at a higher risk than the other scenario we have available to the State of Alaska? Isn't that ... taking more risk for the state, going through process you discussed, than just having you market our gas and send us a check?

UNIDENTIFIED SPEAKER: Well, I would say that there are -- in some areas there's more risk and in some areas there are less. If ... you rely solely on royalty and value, your portfolio is our portfolio; your exposure to the market is our exposure to the market; you sell gas where we sell gas. And so, yes, you ride our coat tails, and that has some benefits from risk mitigation, but it opens up other risks. So, I guess it's in the eye of the state to decide ... whether that's an acceptable proposition or not.

CHAIR THERRIault: Why don't we go to...

SENATOR WAGONER: One other question, just so ... I know. Has anybody done any modeling on this, or are there any figures out there that say what the state gets on this side of the deal and what they get on this side of the deal versus, you know, an LLC versus you marketing our gas? Is there anything ... -- hey, we're going to be in court anyway. I mean, that's inevitable. There's going to be lawsuits come out of this, and gee, we're going to arbitrate these suits so it isn't going to take so long. I mean, that's a good settlement, right? I'm just being... -- but we probably will be in court, and that seems to be the nature of the business.

MR. MCMAHON: ExxonMobil has not done any modeling of that kind.

SENATOR WAGONER: Okay. Has the state done any modeling, Roger, or Ken?

MR. GRIFFIN: Yeah, most of that has been in DNR. We have been working at that quite a bit, and I wouldn't say we've done what I would term modeling, but to try to back up and try to answer your question a little more slowly: We agree 5.5 cent marketing cost is high. We put that in and left it in ... order to make it clear that we had a full -- that costs -- you know, we couldn't be accused of underestimating those marketing costs in the analysis under the contract. Those costs - the marketing costs, the higher of, all these other costs that you have talked about - are incorporated in the modeling for the fiscal contract in the bottom line. As Roger said, you know, we want to look at it as a total deal, the bottom line. These costs are incorporated in there; they're taken into account before we get to the bottom line.

MR. GRIFFIN: ... We do have a commercial gas marketer on board in DNR. We have been looking at the options available to the state as a gas marketer. I'd hoped we'd get into this last week and we ran out of time. But, you know, there's a whole realm of possibilities for the state. We can go from a very minimal marketing organization that simply delivers to the first market and takes spot prices, with ... essentially minimal overhead. We can contract with an aggregator as Mr. Van Tuyl had said, and they handle our marketing in somewhat of a contract nature. We can -- the oil ... and gas companies are not the only marketers in North America. There are a number of sizeable organizations that make their living buying gas or contracting for gas and marketing it around the country. These folks are inherently short on gas. They are astute marketers, very well schooled in the business. They make a living gaining the incremental value with 800 bcf a day, or million cubic feet a day. The state's got a very significant asset to bring to the table to form a partnership with those sorts of people. But all I'm trying to say is this whole spectrum here, they do have various risk profiles to them; they have various potential or incremental value to be added; and these are things that we are studying in DNR right now. ... I think the bottom line is we're going to be able to market our gas. Getting it sold and getting our value I don't believe is going to be the issue. How to best do it is something that deserves a whole lot of attention over these next few months. The bigger issues I think for the marketing organizations are going to be credit issues, tax issues, and things like that. And we're working on those also.

CHAIR THERRIAULT: Mr. Leitzinger.

[5:41:41 PM](#)

DR. LEITZINGER: Thank you. Representative, just an answer to your question, I believe slide 18 of Mr. Pulliam's presentation this morning...

SENATOR WAGONER: Right.

DR. LEITZINGER: ... at line six - maybe you had that exactly in mind - had a model and a (indisc.).

SENATOR WAGONER: Thank you.

CHAIR THERRIAULT: Let's see, Mr. Van Tuyl, you had your hand up; I'm not sure if we've gone past that issue.

MR. VAN TUYL: It's just back to Senator Wagoner's question, and it's very brief. That's the reason that I had read this little excerpt from the MMS annual report, which I'd encourage, I guess everyone to take a look at, that recounts MMS's experience with their RIK program, where they're taking responsibility to market their own gas, when they had decided revenue increases relative to royalty and value. And [I] specifically wanted to reference the statement that conflicts with producers was virtually nonexistent under their RIK program. So, I would submit that their experience would actually suggest that there would be less conflict that what we might have today under the RIV world.

CHAIR THERRIAULT: And Roger.

MR. MARKS: But [I] also want to reiterate that the main reason we're taking our gas in kind is: that's the mechanism that increases the rate of return to the producers. Under the status quo, where we take our gas in value, ... as I said before, we paid for our share of the pipeline slowly over time through the tariff (indisc) on taxes and royalties. On a net present value basis, that hurt the producers, because they shell out all the money up front and get it back slowly over time. If we were to take just ownership of the pipeline, but not taking our gas in kind, we would demand a firm transportation commitment from the producers in order to get our financing. Financially, to them, that commitment ... gets capitalized in their economics and it's no different than shoveling out the money up front. It's only through taking the gas in kind and taking ownership of the pipeline that the producers truly avoid having to pay out 100

percent of the costs up front - you only pay 80 percent of the costs up front - and that way the rate of return is improved, because those upfront costs are removed. So that's -- these other spin off events, by not having conflicts over value, but that's the main reason we did it; it does create marketing risks. We lose the higher of on royalty, but again, in the contract and the modeling it's a total deal, and we believe we ended up ... financially right where we would have been under the status quo, in terms of ... cash flow money.

CHAIR THERRIault: Ken.

MR. GRIFFIN: I just wanted to make one other quick statement. There are some of these "costs" of doing away with the lease terms that are -- we've qualified them and we've identified them, but there's a debate about whether there are real costs that are being given up, even in the first place. And the RIV/RIK switching is a case in point. This is a charter carrier pipeline. There are going to have to be firm commitments made by the individual parties that ship gas. In a practical world, you can't go switching under any reasonable timeframe that means anything. ... Even if we failed the pipeline under today's fiscal structure, the state's going to have to decide right up front whether we're going to take our gas RIV or RIK, and we're probably going to want to do one or the other, because I can assure you that having 800 million cubic feet a day going into the market means a whole lot more than having 80 or 100 or 150. If we're going to set up an (indisc) organization or partner (indisc) organization - whatever we wind up doing - the state's either going to want to do it or we're not. And so, while there are several things I put out, you can see the number of the cost related to giving up RIV/RIK switching. In this world, that option really doesn't exist in the first place.

UNIDENTIFIED SPEAKER: Ken, that figure is not just RIV/RIK switching, right? It's also supposed to shed light at the fact that under the lease you ... got several different provisions (indisc. - overlapping voices).

MR. GRIFFIN: Your number has (indisc. - overlapping voices), I asked what amount. And some of those costs are real. Some of them are going to wind up being litigated, because the state and the producers don't agree with [what] the baseline today really is; it hasn't been truly settled in court. Others are locked to RIV/RIK switching. In this world they're just not going to exist, but your point's exactly right.

UNIDENTIFIED SPEAKER: Yeah, but we've had the several different value (indisc. -- overlapping voices).

MR. GRIFFIN: That's right.

CHAIR THERRIAULT: ... I'm sensing that we're kind of wrapping up, Senator Guess did you have a question? You're up next then. We'll shoot to wrap things up by six here.

[5:46:47 PM](#)

SENATOR GRETCHEN GUESS, Alaska State Legislature: I just had a follow-up on the ownership, because I've heard multiple different things. And if anything's clear out of the round table for me it's that the fiscal interest findings are unclear about what the trade-offs are and why certain decisions were made, at least in my mind after reading them and going through the presentation. But on the ownership portion I've heard, and I believe it was Mr. Clark last week, and then again I've heard this today, "No, we made this decision as a business decision." I think some of the consultants today said that that may be a good business decision to make. Then I've heard other arguments of, "No, we decided to have 20 percent ownership because it improves the IRR now, which is part of the trade-off in the negotiation." Can we get something clear from at least the administration - and my apologies because I only read the fiscal interest findings once, so if it's in there and I missed it, my apologies - exactly what was the story or the reasoning up to saying, "We're going to be an ownership in the pipeline - not the capacity, but the pipeline"?

CHAIR THERRIAULT: Gentlemen, of all 60 legislators, if there's one who's read the fiscal interest findings, it would be Senator Guess. [Indisc - loud ringing sound] ... probably going to have the best understanding with one reading.

UNIDENTIFIED SPEAKER: [pause for unintentional voice over teleconference] ... So, what increases the rate of return is taking the gas in kind rather than the ownership. ... Why we took ownership, it's kind of like I said before, if we didn't have ownership - if we took our gas in kind and owned nothing - we would have to make a firm transportation commitment to the pipeline owners. Again, financially to us, ... that's just about the same thing as ... paying for it. That commitment is a liability. You know, financially you capitalize it; it's like ownership, except what you don't get out of it. You don't get the rate of return on the pipeline and you don't get the seat at

the table. So, what made sense to us, again was this symmetry of having 20 percent ownership - 20 percent of our gas in kind - to get the benefits of ownership and bump up the rate of return.

SENATOR GUESS: But so, am I correct in interpreting that ... it was a business decision versus being driven by the IRR. The capacity was driven -- and I see that ... capacity was driven by IRR; to have capacity ownership makes ... business sense. Am I getting the argument?

UNIDENTIFIED SPEAKER: Even, I guess -- well it made good business sense to do it, but the other point is even if we didn't take ownership, we would have to make the FT commitment, which is financially the same as ownership. But ... what we also got ... out of that was the pipeline income, which is considerable, and the seat at the table. And so, from a business sense, those are certainly good things. So, in that sense you're right, that was business decision.

CHAIR THERRIault: Dr. Van Meurs, are you still on line, because it's been portrayed to me that you were sort of an architect of this section, and I'm wondering if the discussion of the question has covered the answer from your perspective, or do you have something additional to add?

[5:50:39 PM](#)

DR. VAN MEURS: Yeah, no, the decision to participate was taken kind of April, May 2004, I think, and in fact at that time I did the presentation to the legislature precisely on that whole concept. And the concept was indeed to -- because prior to that concept, as you know, ... the ... initial kind of draft application was made in the summer of 2003, then the final application was made in January 2004, and then we started to negotiate, and then we started to zoom in relatively quickly that we needed to do something ... constructive to bring this pipeline about. Already in November 2003, Roger Marks and myself, we had done the analysis of the line; we had come to the conclusion that the gas was stranded; we had come to the conclusion that this was a very low rate of return project, and that consequently we needed to do something. And consequently it was both elements - it was the elements of improving the project rate of return without having to give up ... revenues, at the same time this is a business decision that is, exactly as explained, would bring in regular tariff revenues, would bring in ... 12-14 percent equity return on its investment, so it had all the trapping of -- plus it would create the stability; it

would create a certainty; it would reduce the level of friction and difficulty between the industry and the state. So, somehow, let's say in April, May 2004, we decided to move in that direction, also after having consulted with the legislature at the time, having some meetings with it. I think that was really the time that we decided, for this variety of reasons, that this was a far better structure than negotiating down the royalties or negotiating down the production tax in order to make the project more attractive, or putting very strong, say, concessions in the low prices in order to make this deal, say, acceptable in terms of rate of return on the stress price scenarios. And consequently it was this whole package of concepts that led to this decision. As soon as that decision was made, actually the negotiating phase started to pick up, and we started to crystallize this concept, and then it was in October - as you also referred to before - in the October proposal where this whole concept was flushed out in a great amount of detail to the industry, and they reacted positively to this in December with their counter proposals. So, I think it was not something that ... kind of was a spur-of-the-moment thing; we went through a very lengthy phase of evaluation of alternatives; we came to the conclusion that the alternatives were not attractive to the state and that this was the best overall package.

CHAIR THERRIAULT: Thank you. Roger, wrap up on that.

MR. MARKS: Just [let] me just emphasize just one point Pedro made. You know, very early on in negotiation two things became apparent: One, an evaluation methodology for how the gas was going to be ... valued for taxes and royalties was very important for the producers, certainly in that regard; and two, the state was not prepared to nail down evaluation methodology at that point in time before the pipeline was built. So, again, that's another ... event that led to this outcome where we would take our gas in kind and sell it ourselves to avoid that whole issue.

CHAIR THERRIAULT: Okay. Mr. Van Tuyl, I just want to go back and touch on one thing you said to when I had the question about taking the gas to market and divesting yourself of the risk, and you indicated that well certainly nobody ... had made an offer or this wasn't open season. And, of course, the port authority has been fairly vocal in the past about making an offer, and you and other companies may have determined that to ... not be viable. But when it comes to another company potentially going to another season, have you had the opportunity to review what

would have been contained in a TransCanada proposal? Because their representative, who just left a few minutes ago, I'm sure twitched in her seat when you indicated that there's been no ... open seasons to proposed an independent project. I think they would ... differ and say at least they have tried to get to an open season.

[5:56:08 PM](#)

MR. VAN TUYL: Well, I could think -- an open season is a very definitive event, and anybody is free to conduct one. ... Typically, a party conducting an open season would have done sufficient engineering to be able to define what ... their expected project costs would be, therefore what serve they could offer at what cost. And I guess I was just pointing out that there's a lot of folks that are interested in the project, but really stepping forward to definitively say, "We're prepared to go ahead with the project," the typical way that that does by conducting an open season - a very formal public process.

CHAIR THERRIAULT: Marianne.

MS. KAH: Well I don't know anything about the TransCanada deal, but I would like to comment that I ... could see why pipeline companies would be interested in it, because they're getting the guaranteed rate of return piece. I do -- I can't imagine that there's a lot of companies who are willing to step up and take the firm transportation and price risk, and that's what's missing.

CHAIR THERRIAULT: Another comment, Mr. Van ...

MR. VAN TUYL: Well, just back to that point, our earlier conversation about divesting and whatnot, the thing that had evaporated was just the idea that that's a model ... of producer-initiated pipes that ownership becomes divested through time has happened in Lower 48 pipes, and an example of that is the Alliance Line. I just wanted to...

CHAIR THERRIAULT: And that's what I -- I couldn't think of the name at the time, but I have heard And that causes me a little bit of concern that if we put incentives throughout the system and not just on the pipe itself, the pipe can be, maybe, divested in the future, but the incentives are somewhere other than on the pipe. And the State of Alaska could say, "We're going to take \$2 billion and we're going to pay down debt, and we're going to let that benefit flow through to all shippers."

Because when you ship, when we ship, when somebody else ships -- but that would all be tied to the pipe itself.

MR. VAN TUYL: But regardless of whether that divestiture had occurred or not, the ... pipeline would be constructed, would be flowing, folks would be benefiting from that project, and all the obligations under the contract would still be being performed, either by the original entity or by the subsequent assignee. So, that net picture looks the same. The names on the checks may change, but all the obligations under the contract still need to be performed.

CHAIR THERRIault: Okay, it's just before six o'clock, are there any other questions? Okay, thank you, I hope all the elected officials agree with me: I think this is valuable discussion. I'm thankful that the governor did announce today that there is a longer period of time for the public comment; I think that's valuable for the citizens who are out doing things in the midnight sun - it's tough to catch their attention this time of year. But also, the ... smaller producers in the state - I think it helped them to know exactly how long they have to put together their comments, and I expect that their comment will have some concerns that are concerns of the state also, as ... the state being a sovereign. So, thank you very much for your participation today, and with that we will conclude.

[5:59:32 PM](#)

ADJOURNMENT

There being no further business before the committee, the Legislative Budget and Audit Committee meeting was adjourned at 5:59 p.m.