

ALASKA STATE LEGISLATURE
SENATE SPECIAL COMMITTEE ON NATURAL GAS DEVELOPMENT
Fairbanks, Alaska
July 6, 2006
8:56 a.m.

MEMBERS PRESENT

Senator Ralph Seekins, Chair
Senator Bert Stedman
Senator Donny Olson
Senator Ben Stevens
Senator Kim Elton

MEMBERS ABSENT

Senator Lyda Green
Senator Gary Wilken
Senator Fred Dyson
Senator Lyman Hoffman
Senator Thomas Wagoner
Senator Con Bunde
Senator Albert Kookesh

OTHER LEGISLATORS PRESENT

Representative Jay Ramras
Representative David Guttenberg
Representative Michael Kelly

COMMITTEE CALENDAR

Roundtable Question and Answer Session - Legislators,
Consultants, Producers, Administration

PREVIOUS COMMITTEE ACTION

No previous action to record

WITNESS REGISTER

UNITED STATES SENATOR LISA MURKOWSKI
709 W 9th St., Rm 971
Juneau AK 99801

POSITION STATEMENT: Addressed the Senate Special Committee on
Natural Gas Development

JIM CLARK, Chief Negotiator
Office of the Governor
PO Box 110001
Juneau, AK 99811-0001

POSITION STATEMENT: Participated in the round table discussion

ROGER MARKS, Economist
Department of Revenue
PO Box 110400
Juneau, AK 99811-0400

POSITION STATEMENT: Participated in the round table discussion

WENDY KING, Director Of External Strategies
ANS Gas Development Team
ConocoPhillips Alaska, Inc.
PO Box 100360
Anchorage, AK 99510

POSITION STATEMENT: Participated in the round table discussion

BOB LOEFFLER
Morrison & Foerster
Counsel to the Governor
Office of the Governor
PO Box 110001
Juneau, AK 99811-0001

POSITION STATEMENT: Participated in the round table discussion

DAN DICKINSON, CPA
Consultant to the Governor
Office of the Governor
PO Box 110001
Juneau, AK 99811-0001

POSITION STATEMENT: Participated in the round table discussion

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

POSITION STATEMENT: Participated in the round table discussion

DAVID VAN TUYL, Commercial Manager
Alaska Gas Group
BP Alaska
Anchorage, AK

POSITION STATEMENT: Participated in the round table discussion

JIM EASON, Consultant

Legislative Budget and Audit Committee
Alaska State Capitol
Juneau, AK 99801-1182

POSITION STATEMENT: Participated in the round table discussion

DON SHEPLER

Greenberg Traurig, LLP
Consultant to the Legislative Budget and Audit Committee
Alaska State Capitol
Juneau, AK 99801-1182

POSITION STATEMENT: Participated in the round table discussion

PHILLIP GILDAN

Greenberg Traurig, LLP
Consultant to the Legislative Budget and Audit Committee
Alaska State Capitol
Juneau, AK 99801-1182

POSITION STATEMENT: Participated in the round table discussion

RICK HARPER

Econ One Research, Inc
Consultant to the Legislature
333 Clay Street
Houston, TX 77002

POSITION STATEMENT: Participated in the round table discussion

GREG O'CLARAY, Commissioner
Department of Labor & Workforce
Development
PO Box 21149

Juneau, AK 99802-1149

POSITION STATEMENT: Participated in the round table discussion

JIM LITHY, Business Manager
Plumbers and Pipefitters Local 375
No address provided

POSITION STATEMENT: Presented concerns over the lack of a project labor agreement

JIM SAMPSON, President
Alaska AFL-CIO
No address provided

POSITION STATEMENT: Encouraged committee members to incorporate a project labor agreement into the contract

ACTION NARRATIVE

CHAIR RALPH SEEKINS called the Senate Special Committee on Natural Gas Development meeting to order at [9:13:04 AM](#). Present at the call to order were Senators Kim Elton, Ben Stevens, Bert Stedman, Donny Olson and Representatives Michael Kelly, Jay Ramras, David Guttenberg, John Coghill, and Chair Ralph Seekins.

**Roundtable Question and Answer Session - Legislators,
Consultants, Producers, Administration**

[9:13:04 AM](#)

CHAIR RALPH SEEKINS announced the committee would continue its roundtable discussion among legislators, consultants, producers and the administration. He recognized Roger Marks, Jim Clark, Bill McMahon, Wendy King and Dave Van Tuyl at the table.

[9:14:36 AM](#)

CHAIR SEEKINS announced the agenda for the meeting. United States Senator Lisa Murkowski will address the committee at approximately 1:30 PM via teleconference. United States Senator Ted Stevens will attend the next committee meeting.

[9:16:05 AM](#)

JIM CLARK, Chief Negotiator, thanked the committee for holding the meetings and advised them that the governor's staff prepared handouts for the members, which address the important points of the contract. The document is intended to append to the fiscal contract. He asked committee members to add their suggestions. He advised that Mr. Marks would speak about the reason the State decided to take its gas in-kind.

[9:18:45 AM](#)

ROGER MARKS, Economist, advised he would give an overview consisting of three different issues: How the State sees the project, the roll of the Stranded Gas Development Act (SGDA), and the structure of the contract.

The astronomical size of the contract tends to magnify all of the risks, the two main risks being price and cost. Prices are "utterly unknowable," and in fact six years ago the State forecasted oil prices to be at \$17.22 in 2006. Yesterday it closed at more than \$71 dollars. In the future though, prices could fall to \$2 a barrel. Clean coal is becoming increasingly economic as well as natural gas. Global warming could cause a "throttling back" in the use of hydrocarbons. Somebody could perfect nuclear fusion, causing the end of hydrocarbons. All of

these things could contribute to the end of high oil prices, he said.

[9:21:24 AM](#)

Mega projects are very complicated and there tends to be a snowball effect when things go wrong. Large cost overruns are not unusual and cause huge problems. Depending how cost and price turns out, this project could turn out to be very good or very bad, he continued. Mr. Marks offered a hypothetical example of a family whose annual income was \$50,000. If offered a chance to roll the dice for double or nothing, most people would decline the bet. That is the reason that investors look at risks asymmetrically. The downside would be far worse than the upside would be good. Because of the high cost and long construction period the project is a low rate of return project compared to other investment opportunities that investors have around the world.

[9:24:07 AM](#)

The Stranded Gas Development Act (SGDA) was intended to do two things. It was meant to custom tailor the fiscal system to suit the particular project as it came about and it was meant to give the producers fiscal stability so there is a proper balance of risk and potential. The contract does both of those things, he advised. It gives fiscal stability and is custom tailored to the economics. The contract increases the rate of return to the project. The project itself presents a relatively low rate of return and because of the unique risks it will need a higher rate of return to be feasible.

Hurdle rate is the rate of return that a company needs in order to pay off capital and investors. The hurdle rate of this project will be fairly high due to the risks involved so the State's philosophy is to increase the rate of return, which will make the project more viable. The main instrument used in the contract was taking the gas in-kind. Under the status quo where the State takes taxes in royalty and value, the State really pays for its share of the gas over time slowly through the tariff deduction. Taking the gas in kind essentially makes a firm transportation (FT) commitment to the producers, which is seen by them as an asset. It works as if the State is paying the 20 percent up front. In other words, under the status quo the producers are laying out the money up front for the State's 20 percent of the gas and because of the net present value that is a depressant on the rate of return. By Alaska making the FT commitment up front, financially that is the same as if Alaska

were paying the 20 percent up front and it increases the rate of return, he stated.

[9:28:41 AM](#)

MR. MARKS continued the State estimates that by doing so it gets 2 to 2.5 percent of the rate of return on the project, which is rather large. That rate of return is the same as what the rate would increase to under the status quo if Alaska relinquished all of the taxes, but by taking the gas in kind Alaska gives up nothing. The State gets the exact same amount of revenue but yet increases the rate of return considerably. The amount of the increase of the rate of return is equal to \$1.20 per million Btu for 50 trillion cubic feet or equivalent to decreasing the capital cost by \$4 billion dollars.

By taking the gas in kind and making the FT commitment, financially that is the same as ownership and so the State decided to do just that. By taking ownership, the State aligns itself with the producers and gets a seat and a voice at the table. There are many risks involved but the Administration believes the risks are not "incredibly hazardous." In return for the risks Alaska gets a gas line, which is a great thing. By the State taking its gas in kind it has the opportunity to decide as a matter of policy the terms and the price and who to sell the gas to. The State will have more than enough gas to supply in-state needs.

[9:32:11 AM](#)

Currently the prices in Chicago are approximately \$6 dollars with the added mileage-based tariff, and so for example Fairbanks would have the cheapest gas in the country.

[9:32:29 AM](#)

CHAIR SEEKINS interrupted Mr. Marks to say he understood in the contract the tariff for in-state gas was proportional. He asked whether there was a penalty if the State takes gas off in Fairbanks instead of sending it to the Lower 48.

MR. MARKS posed a hypothetical example where the price of gas in Chicago was \$6. The State has the choice of selling it to Chicago for \$6 and paying \$2.50 to get it there or to just sell it at the wellhead for \$3.50.

SENATOR KIM ELTON interjected the State, as equity owner of the pipeline, would be paying the \$2.50 tariff partially to itself.

MR. MARKS said that is exactly right but if the State chose to sell 100 percent of its 20 percent piece at the wellhead, it wouldn't have to invest downstream.

SENATOR ELTON countered it was not that simple. In order to realize the same return the State would have to sell the gas in Fairbanks at a higher price in order to realize the same return because at a 20 percent ownership the State would get 20 percent of that \$2.50 transportation cost.

MR. MARKS responded if the State puts out \$4 billion dollars to the project and pays itself a tariff on that money, the State would come out neutral. "It's a wash," he said.

MR. CLARK added the Administration is developing the policies that back up the in-state use of gas and it is a complicated endeavor. He asked Chair Seekins whether Bob Loeffler could comment on the complexities associated with the policies and answer Senator Elton's question.

CHAIR SEEKINS announced a recess at [9:36:19 AM](#).

[9:42:55 AM](#)

CHAIR SEEKINS called the meeting back to order.

BOB LOEFFLER, Counsel to Governor Frank Murkowski, said the Administration has been listening to the concerns of the public in regards to serving in-state needs. He assured members that they were developing a policy for use of some of the State's gas. The State's share will exceed all potential uses of the gas in state. The bidding opportunities will be made available before the federal mainline open season so that it is timed precisely. The State must decide what best serves the citizens of Alaska in terms of pricing. In a bidding opportunity people might bid more than netback price because they may be looking at the heating value equivalent to the very expensive oil.

[9:48:08 AM](#)

The State must decide who would be responsible for the capacity for in-state use. The State must also be sure that the amount of gas that is being taken off in state does not negatively affect the amount that needs to flow through the "big line." There has to be an opportunity for in-state users to bid for gas and the State must set the pricing.

MR. CLARK added the Administration is developing policies to attach to the fiscal contract. The contract does not speak to

how the State of Alaska would use its own gas. That would be developed over time.

[9:51:21 AM](#)

REPRESENTATIVE JOHN COGHILL asked Mr. Loeffler to clarify whether the Administration was developing both an economic policy and a structural policy to determine who would get pipeline capacity from Alaska on.

MR. LOEFFLER said that was right. "We hope to develop a policy that will satisfy reasonable in-state use and not undermine the economics by taking the full 20 percent," he said.

MR. CLARK advised the Administration believes the policy has to be developed as soon as possible. They intend to do whatever it takes to find out how much gas will be taken off prior to the open season. The pipeline will be designed in the open season.

[9:53:53 AM](#)

MR. LOEFFLER added the contract requires that there be a study of in-state use before the open season. "The pipeline has to do that, not the State, so that the contract recognizes the timing issue," he said.

DAVID VAN TUYL, Commercial Manager, BP Alaska, mentioned a study to be done by the pipeline, which would evaluate potential for a natural gas pipeline in Alaska and that would "stir into the mix" about where gas was likely to be taken off. The contract envisions in-state gas use and Article 10 provides for notice to be given about the portion to be dedicated to in-state use. There has been talk about a telescope design that starts in Fairbanks but the size of the pipe has yet to be determined. BP Alaska would prefer to sell to customers in Alaska than have to transport it to Chicago, he said. He questioned how BP could compete with the State since the State does not pay federal income tax but added it "would like the opportunity to compete."

[9:56:15 AM](#)

MR. MARKS said there is no reason to believe there isn't enough gas to go around. If the State takes a large amount of gas for in-state use it would not necessarily be detrimental for downstream economics.

REPRESENTATIVE COGHILL asked whether the State would still anticipate a 20 percent FT commitment if it takes all its gas for use in state.

MR. LOEFFLER said no. In the federal open season the State would bid for what it needed in state and then subtract that from the 20 percent.

CHAIR SEEKINS asked how the State would handle the infrastructure and time that it would take for a community of 90,000 people to switch from an oil to a gas economy.

MR. LOEFFLER replied that scenario would present itself as a tremendous business opportunity. The price of heating oil is far higher than natural gas will ever be, he stated.

MR. MARKS surmised 70 percent of the homes in Fairbanks use heating oil and the price right now is about \$2.50 per gallon. A family could expect to save 80 percent by switching to natural gas.

CHAIR SEEKINS offered with proportional tariff there is no state subsidy to the consumer but it greatly reduces the cost of heating a home in the interior of Alaska.

MR. MARKS added that also depends on how much the State decides to sell the gas for.

MR. LOEFFLER advised the State could put the gas out for competitive bid and there would be ample opportunity for competing business.

10:01:26 AM

KEN GRIFFIN, Deputy Commissioner, Department of Natural Resources (DNR), commented Alaska has distribution companies that could provide the committee with good information of what the expected penetration would be for different communities. He suggested that question be submitted to people in the distribution industry.

The north end of the pipeline will be the most expensive part to build largely because of terrain. In addition, the transportation lines are all incurred up north so it would be incorrect to assume that Fairbanks would pay a quarter of the \$2.50 total tariff to Chicago. Fairbanks would pay the North Slope line costs, the GTP costs and the northern quarter end of the pipeline. Negotiated into the contract is the assurance that Alaska users will not subsidize the line downstream.

MR. LOEFFLER interjected the likely tariff structure under the Federal Energy Regulatory Commission (FERC) rules is that there

will be a separate tariff for the GTP and then a tariff for the pipeline downward from the GTP. The tariff on the GTP might logically be based on the volume of gas going through it without regard for where it is going, he said, and then the rest of the tariff is mileage sensitive.

SENATOR BEN STEVENS asked a few questions regarding the forecasted volumes of in-state use. He queried the estimated volume that the State would require in the initial open season. He asked the frequency of future open seasons and also asked whether any state-initiated expansion could be limited to in-state volumes.

MR. LOEFFLER said the frequency of future open seasons is unknown but would depend on additional gas becoming available. The state-initiated expansion is designed for expansion in state.

[10:06:18 AM](#)

SENATOR BEN STEVENS expressed concern that there will be a lack of certainty of volume and demand shipped to South Central Alaska. He said there would be no burden on long haul rates and said it would be subject to the proportional rate on the main line as well as the tariff set by the RCA.

MR. LOEFFLER agreed and said the State would have to acquire enough gas to serve in-state needs.

[10:07:34 AM](#)

SENATOR BEN STEVENS said there is not enough proven reserves to fill the gas line as it is. He asked whether it was anticipated that exploration would meet in-state demand as it grows.

WENDY KING, ConocoPhillips, speculated continued exploration would find enough gas to serve in-state needs. There is nothing to preclude a voluntary expansion from happening at any given time.

MR. VAN TUYL said BP Alaska believes the North Slope is a "gas prospective area." The USGS, the NMFS and the State of Alaska all have estimated future potential gas resources in the range of 100-200 trillion cubic feet in addition to the 35 trillion cubic feet known today. The producers want and need the pipelines to be full for many decades to come.

SENATOR BEN STEVENS restated his concern that the State would not be able to meet future commercial demands for the South

Central region of Alaska. He asked Mr. Clark to outline the mitigated attempts in the contract that would meet the business demands.

MR. CLARK said there are several things to keep in mind. First the policies must be established before the first open season. The pricing issue is unresolved and there are currently three choices: the netback plus transportation, the netback plus transportation plus a bidding premium, or price the gas at the Henry Hub rate. The contract contemplates that the opportunity to use the gas is the policy the Administration will follow.

There are three different ways that somebody can initiate an expansion if they find gas. The Administration believes the pressure will expand as the residents of Alaska begin using more and more gas. The policies will be pro-exploration and the cost of the gas is expected to be far cheaper than current heating expenses so that will drive the expansion, he stated. The opportunity is there because the State is taking its gas in kind.

[10:14:45 AM](#)

CHAIR SEEKINS aired the communities in-state want access to the gas, South Central depends on gas, and heating costs are a big expense to the residents. He asked whether there was access to the "liquid petrol chemical in-state without affecting the downstream economics of the project."

MR. MARKS said Alaska would get 20 percent and that includes a "lot of liquid." There will be a study done of the potential for liquid petrol chemical industry in Alaska as well.

REPRESENTATIVE MICHAEL KELLY stated it was important to recognize what the State was giving up. If it were to take the gas in value initially, it would be able to take it at a rate that would match the growth in state. He said it was important to recognize that a lot of people were carefully watching and they know what is being given up. Alaska is a young state without a clue as to what it will be using for gas in a decade and many residents will never have access to the pipe. He suggested that by taking all the gas in kind Alaska would be giving up a significant advantage. "Trying to do an open season in Alaska with no infrastructure is a wild shot in the dark," he commented.

[10:19:14 AM](#)

MR. CLARK responded the notion of giving up royalty in value is not true. "If there is no gas line you're not giving up anything," he stated. Taking the gas in kind is what made the agreement occur. He suggested the contract would not have gone through if Alaska had not taken the gas in kind. "You have to have it before you can give it up," he said. He added the Administration is looking at using the take-off point north of the Yukon to see whether there is a possibility for the State to take off some of the propane or butane and use the barge system to reduce energy costs in rural Alaska. That would happen during the first open season not down the line, he said.

[10:21:59 AM](#)

REPRESENTATIVE DAVID GUTTENBERG stated there was very little economic benefit from proximity to the pipeline and noted that the price at the gas pump in Alaska is top in the nation. He said he was waiting to see whether the contract would give consumers a reasonable price for gas once the distribution gets to the household. At a hearing in Fairbanks last year a gentleman spoke about conversion to gas and indicated it would cost approximately \$10,000 per household. That brings about the question of whether a pipeline through town would economically benefit the consumer. The gas will be available but the end market price is unknown at this point. In rural Alaska the price of energy is directly related to economic development, he stated.

[10:24:38 AM](#)

CHAIR SEEKINS said the question that Representative Guttenberg raised is not a question relative specifically to the project but is a policy decision that has to be made outside of the consideration of the project.

MR. CLARK agreed but advised the contract leaves the State the flexibility to make policy decisions. The Administration is committed to getting the policies made. The policies will be accommodated in the pipeline study and that will be taken into consideration when it is time for the first open season. The Administration must be mindful of the difference between the oil and the gas pipeline and how they both work.

CHAIR SEEKINS called a recess to repair the feed on the network.

[10:37:43 AM](#)

CHAIR SEEKINS called the meeting back to order.

MR. CLARK asked to address the issue of conversion as the Department of Energy (DOE) addressed it. He said Mr. Loeffler would speak about the difference between a gas and an oil pipeline.

MR. LOEFFLER referred to the DOE study dated June 2006 and noted page 42 says, "Estimated costs to converting 15 residential oil burners to gas are \$1400 when the burners can be changed out and \$3000 when the entire unit needs to be replaced." The conversion cost seems reasonable and utilities sometimes offer financing for the conversion.

MR. MARKS referred to people off the distribution system and said the 4 billion cubic feet a day will have approximately 30,000 barrels a day of propane. Twenty percent of that is 250,000 gallons of propane a day that the State would have at its disposal. That propane could be used for people off the distribution system.

CHAIR SEEKINS asked whether that propane would be cheaper than it is now.

MR. MARKS said it could be much cheaper.

SENATOR BERT STEDMAN commented his area of representation would never have access to the gasline but for those that do, the market would dictate what the price would be. He said it was a legislative policy decision as to what kind of break others would get. The value is in the energy itself.

10:42:20 AM

MR. CLARK said there are three very reasonable pricing choices in front of the State. There is the Henry Hub price for distribution, the netback plus transportation, or the netback plus transportation and then putting it out to bid. Those would be less than the prices today, he speculated.

MR. LOEFFLER advised there would be a robust discussion in the Administration about the choices to ensure that the State uses the maximum value of the product.

MR. CLARK interrupted to say the contract provides the flexibility to make those policy decisions.

CHAIR SEEKINS asked Mr. Clark whether the State had a choice between royalty in kind and royalty in value.

MR. CLARK deferred to Mr. Loeffler and said he would define the difference between oil TAPS management and gas lines.

MR. LOEFFLER said the basic gas line world is financed using the FT commitments.

10:45:05 AM

CHAIR SEEKINS asked for a definition of FT.

MR. LOEFFLER said FT stood for "firm transportation." It is buying a ticket on the gas line for a long period of time and committing to use that ticket to ship the gas. That is what happens at the open season and is the core commitment of how a gas line is structured. "Someone has to sign up for that big capacity in the beginning and so if we take it in value we're paying for someone else who is signing up for that capacity," he said. The bank looks for financially responsible people who will use the line and pay it off.

TAPS is a different scheme and a weird legal structure. Originally there were eight pipelines in one pipeline, legally speaking. Each pipeline company owned its own stakes. Each company put out a tariff for its space. The notion of the State paying itself is true on the TAPS line but this gas line is one tariff and whatever proceeds are received go into one pot that is divided among the owners of the LLC according to their percentage interest.

In TAPS capacity is bid every thirty days. In the past shippers guaranteed that agreement but now each remaining owner posts the available capacity and people bid on it. It is short term and so there is no huge FT commitment like the one that is essential to the gas line. "It's a different world," he said.

10:48:34 AM

MR. MARKS said he would discuss how taking the gas in kind increases the rate of return to the project. It is generally a low rate of return project and the Administration is looking to increase that rate of return. There are four states of the world, he said. The first is status quo or in value, where producers have 100 percent of the gas and pay 100 percent of the costs. In value the State pays for its share of the pipeline slowly over time through the tariff deduction on the royalties and taxes. In that world, because of the time value of money and the net present value, that suppresses the rate of return.

The second state of the world would be where the State owns 20 percent of the pipe and takes its gas in value. In that case the State would insist on an FT commitment from the producers. That is how the State would get its financing and the certificate from FERC. In this world, financially the producers would see no real difference and they would see no improvement in the rate of return.

The third state of the world would be where Alaska takes its gas in kind but does not take ownership. In this case the producers would insist on an FT commitment from the State. In that case the producers would only pay 80 percent up front and that would increase their rate of return. The State decided that financially an FT commitment is similar to ownership and along with ownership the State gets a seat at the table.

The contract evolved to the fourth state of the world where the State takes the gas in kind and also takes ownership. Taking the gas in kind made the contract doable. It increases the rate of return for all and adds benefits for the State.

[10:52:38 AM](#)

MR. LOEFFLER asked the committee to think about in-state users in the Cook Inlet area. Those needs are much more identifiable than petrol chemical use and so it is possible that someone could commit in the open season for a volume of gas from the State for commercial purposes. That could easily happen and so it is not fair to say that nobody in Alaska will be ready in time for the open season.

The pipeline would probably be built five years after the initial open season and so people will have plenty of time to prepare a commercial enterprise without having to pay on the commitment right away.

CHAIR SEEKINS asked how long it would be after approval of the contract to the first open season.

MR. LOEFFLER speculated it would be one to two years.

[10:54:42 AM](#)

CHAIR SEEKINS noted it would be six to eight years before the first payment would be due on the FT commitment.

MR. CLARK said Mr. Loeffler misspoke on one point. If Alaska did not take the gas in kind the producers would end up with 100 percent of the cost but 80 percent of the gas. That is where the

economics suffer. Alaska chose to take 20 percent of the gas and also pay 20 percent of the costs so that sealed the alignment. Looking at the capacity article, Alaska would be "riding the coattails of the producers" in regards to the capacity management. The State has the producers doing the processing. Alaska also has an advantage because the State does not pay federal taxes.

[10:57:41 AM](#)

SENATOR BEN STEVENS asked Mr. Dickinson to respond to his next question. It was his understanding that under the distribution of revenues under the State's system with oil, the revenue received from royalty is equal to the revenue received from tax oil. He asked whether that was accurate.

DAN DICKINSON, Consultant to the Governor, introduced himself as the former director of the tax division and said due to the ELF, the collections from the severance taxes fall below. If you add together severance tax and income and property tax that is about the same as the royalty. The severance tax went from being higher than the royalties to being lower.

SENATOR BEN STEVENS said he wanted to differentiate from what the State gives up and what it potentially would gain. Specifically the package is put together so that the State takes 20 percent ownership and 20 percent capacity. The 12.5 percent royalty in value is a policy call and the 7.5 percent tax gas is a policy call. He asked for an explanation of the risks and benefits associated with taking the tax gas in value. He said the way he sees it, Alaska captures all the upside on the severance gas and then loses on the downside because when the value of the gas falls, the tax revenue falls. "We lose the upside if we take it in kind but yet we hold the downside when we take it in kind," he said. In contrast to having a discussion about what is lost by taking the gas in kind, he said he wanted to talk about what Alaska gains by taking the gas in kind.

[11:01:01 AM](#)

MR. DICKINSON observed that when an entity increases the total amount taken in kind, it puts that entity in a different position as a marketer. The larger the volume the more effective marketing a company can employ. "The amount of gas that we increase as takes, our upside also increases," he said. The State is still getting considerable cash flows from the PILT that replaces the income tax and the property tax so the State is getting significant cash flows from the payments in lieu of tax.

SENATOR BEN STEVENS opined the royalty piece was a policy call to take the gas in value or in kind. However there is more upside on taking severance production in kind than in value.

MR. MARKS responded financially the results are the same. The "magic of the contract when taking the gas in kind" is Alaska increases the rate of return and doesn't give up a thing. One advantage of taking the gas in kind is that Alaska has the option of what to do with the gas within the state.

MR. CLARK added the Mineral Management Service (MMS), a federal agency, is taking its gas in kind more and more and they are making money. It's turning out to be a one to two percent increase over taking the gas in value.

MR. GRIFFIN agreed and said the MMS has been taking their gas in kind for several years, yet theirs is a different world than what Alaska is talking about. In their world they are not making capacity commitments.

[11:06:44 AM](#)

MR. VAN TUYL, Commercial Manager, Alaska Gas Group BP, said the earliest reference (to taking gas in kind) in the MMS newsletter goes back to 1998. In April 2004 its national presentation indicated they experienced many benefits from that decision. Some benefits include conflict avoidance with the industry, reduced administrative costs, earlier revenue receipts, and increased responsiveness to government energy programs. In April 2006 they issued a financial report, which indicated their program performance far out-paced the program goals. Administrative costs continued to decrease, revenues continued to increase and conflict with producers was non-existent.

[11:09:28 AM](#)

SENATOR BEN STEVENS asked for distribution of the newsletter. He asked for an estimate of the volume that the MMS was talking about.

MR. VAN TUYL said that volume was cited in their fiscal report but he didn't have that number at present.

MR. LOEFFLER advised that the reports were all available on the MMS website.

MR. CLARK observed that the person currently in charge of the MMS program is a former commissioner of the Department of Revenue in Wyoming and might be somebody worth talking to.

[11:10:32 AM](#)

MR. VAN TUYL advised the volume was converted to barrels of oil equivalent and was 82,364,035 taken in kind and sold during FY05.

MS. KING quoted from the MMS newsletter of April 3, 2006 and said the federal lease in the Gulf of Mexico is projected to provide delivery of 118 bcf of gas over a 7-12 month term. That equates to approximately 510 million Btu per day. They had a record number of bids for the gas.

SENATOR BEN STEVENS asked whether that meant they were oversubscribed.

MS. KING replied there was "quite a bit of interest."

MR. GRIFFIN addressed Senator Stevens' question and said the cost of marketing is included in the bottom line and is similar to the RIV world. The MMS information indicates that Alaska was conservative in estimating the cost of administering and marketing the gas. The legal costs over valuations will most likely go away and that was not addressed in the economics. The State also did not put any value on the marketing burden.

Fundamentally the benefit of Alaska taking its gas in kind is "moving the pipeline forward and getting it going." The value of royalty switching is nonexistent in the gas transportation world, he said. Practically speaking that opportunity will not present itself. Alaska will have 800 million cubic feet a day to market. It will be delivered into the center of one of the largest markets in North America and that will give Alaska significant leverage, whether it decides to partner or contract or move ahead as an independent marketing entity.

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MR. GRIFFIN continued along that line - were Alaska to take its gas in value, it would be dependent upon the oil companies to market and pay the royalties. Each company has a different strategy and Alaska would be captive to that. Some companies are aggressive risk-takers and some are conservative marketers. Those would be choices that the State would be bound to, he stated.

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MR. GRIFFIN added in-state policies would be met and that is an outflow of taking the gas in kind. In conclusion, he said, do not underestimate the importance of eliminating valuation disputes. Most valuation disputes are good faith disputes but they are deep-seeded and hard fought. They create friction between companies and make it difficult to function effectively as partners.

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SENATOR STEDMAN asked whether major producers were excluded from marketing for Alaska if the State chose to go with the 20 percent.

MR. CLARK replied no. The matter was discussed internally and the Administration wants to come up with an in-state team with expertise similar to the Permanent Fund. The State would attempt to manage a group of marketers, some from the producers and some from outside the industry. The State would compare results to determine the most effective campaign and drop the others. In short, it would be competitive and the State would do comparative shopping.

SENATOR STEDMAN referred to efficiency in scale when teaming up with a producer and asked whether that potential value was considered.

MR. CLARK said Alaska would have enough gas to "split it out and make it work."

MR. GRIFFIN added there are a number of ways to organize a state marketing organization. All of them have overhead and risks. The DNR is studying them and making contact with other entities and looking at various alternatives. He said he could not tell the committee how Alaska plans to market the gas because "we're not there yet."

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MR. GRIFFIN continued if Alaska were to turn the gas back over to the producers it would be difficult to avoid the valuation issues that they currently have. He questioned the advantage of doing so. There are many effective gas marketers throughout the United States and North America and many of them do not have their own gas supply. They contract for it and re-sell it.

[11:22:49 AM](#)

SENATOR STEDMAN asked whether the State could control more of the market with just sheer volume.

MR. VAN TUYL commented on the volume relationship and said they looked at aggregators like they were buying a mutual fund. There are marketing organizations that will take gas supplies from various sellers and pool it together for a market price. They quote their fees for the service on a website. Today's quotes range from a fraction of a cent per million Btu to five cents. The primary differentiator on the fee is the volume.

MS. KING offered to follow up on a point made by Senator Ben Stevens. The question regarded options created by taking tax gas in lieu of cash payment. As an explorer, she said, she could envision a scenario where more and more gas could come from federal lands rather than state lands. The contract sets up a mechanism by which the State elected to take the tax gas in lieu of cash payment so in the future if gas production moves to federal lands, the State will still be preserving the option of having some gas in kind from the tax gas. That gas would be used to fill in-state needs.

MS. KING added the ownership would last for as long as the State desires to maintain the 20 percent ownership beyond the life of the fiscal contract. So if gas moves more and more to federal lands there is a source of revenue through the ownership that the State will be receiving from that gas. The State doesn't necessarily have to own that gas for the life of the pipe. It can still receive the distribution. Those are two new opportunities set up by the contract, she said.

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SENATOR DONNY OLSON noted perception of the general public is that marketing of the royalty oil has not gone very well. He asked Mr. Clark how to stay out of the pitfalls.

MR. CLARK deferred to Mr. Griffin.

MR. GRIFFIN said the quick answer is the State has taken a significant amount of state oil and sold it in kind. In these commitments sometimes you win and sometimes you lose, he said. In the latest in kind contract, Alaska is receiving a significant premium over what it would be receiving in value. The difference is when there is a limited amount and the State has a limited number of contracts. "Each contract depends on the crystal ball you're using that particular day," he said. He referred to the estimated volume of gas and said the risk

management strategies and the opportunities to diversify the portfolio go way up. He expected the performance to be much less spotty. The State has been more successful than the public portrays, he said. He added the Permanent Fund is managing a large portfolio and that is parallel to what the State will be doing with the gas portfolio.

11:29:29 AM

MR. DICKINSON responded to Senator Olson's question and said he did an expert report on that very question ten years ago. Alaska tried to get a good financial return, but the residents were disappointed because they felt there should have been some non-financial benefits as well. The current contracts have premiums built in so the State is doing better.

MR. LOEFFLER said speaking as a lawyer when one thinks about the comparison between in kind and in value, the State engaged in huge amounts of litigation to achieve the result in value and every case has been settled on the royalty side.

MR. CLARK said in short when negotiating in any oil situation the Administration looked back and the State always gave up value in order to get a settlement and move on. That won't be an issue if Alaska takes the gas in kind.

CHAIR SEEKINS advised the committee Don Shepler, Jim Eason, and Phillip Gildan were on line if anyone needed to question them. He referred to Flint Hills and asked Mr. Clark whether those people would pay a premium for royalty oil.

MR. CLARK said yes. As he recalled it was between a \$6 million and \$8 million premium. Mr. Griffin would know, he said.

CHAIR SEEKINS said the reason for the premium is due to the residents of Alaska who won't see the gas but still should gain some value from it.

MR. CLARK said the Legislative Branch and the Executive Branch must decide the policy on in-state sales. The contract leaves all the policy choices available.

CHAIR SEEKINS commented that policy might be settled in court due to constitutional interpretation of maximum value.

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REPRESENTATIVE KELLY said the mileage-sensitive rate would provide a tremendous benefit for residents in Fairbanks and

other areas of Alaska. He asked why the State would want to delve into ownership of the pipeline if Alaskans were going to be able to use the entire State's share of the gas and he asked whether Alaska would benefit more by using all of the gas in state.

MR. CLARK said the short answer is it's a policy call. The State wants the pipeline built and the gas sold. There are tax issues beyond the gas in kind. The State also wants to encourage exploration on the North Slope. If the State takes all of its gas it could undermine the economics of going all the way to the major North American markets, he said. The State needs to take enough gas to fill in-state needs but there is a point where the State needs to ensure that there is enough gas going down the pipeline to finance the whole deal.

From a risk standpoint the State has to look at the possibility of delivering gas as far away as the New England market and take advantage of all the diverse economics from the West Coast to the East Coast of North America.

REPRESENTATIVE KELLY referred to earlier conversation of what it would take to ensure that Alaska gets the pipeline built and said his point was if Alaska did not need the line for subsidy in making the deal more attractive for the producers then the State would not want ownership on a mileage-sensitive rate.

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MR. CLARK responded it's a question of putting up 100 percent of the cost up and getting only 80 percent of the gas. He posed a hypothetical example:

Let's say that the petrochemical ferry arrives in Delta and we have now the ability to take off 850 million cubic feet per day in Delta and run it there. So what we would do is still take our gas in kind and we'd take it to Delta. From there, just think about what's happening. The line would be smaller because if we were taking off 850 million they're going to telescope the line and the cost would be from Delta forward. They would pay 100 percent of the cost from there but they get 100 percent of the gas. So there would be that match up that we don't have now. And it's because we don't have the match up, when they're forced to pay 100 percent of the cost but only get 80 percent of the gas, that's where the mis-alignment occurs and what we fixed was to make it that they're

going to pay 80 percent of the cost and get 80 percent of the gas. In your example, we would still have that perfect alignment because we would pay our 20 percent share to Delta but the line would be smaller, the cost would be less going forward to take the gas to market and they would get 100 percent of the gas for 100 percent of the cost. So the alignment is still there. It's those terms in which we need to think of it. That's where from the analysis that Dr. Pedro van Muers and Roger [Marks] did at the time was why it makes the deal because it creates that alignment of cost and revenues.

MR. LOEFFLER submitted he had trouble with that hypothetical because it references a sliding scale. He said he didn't see how that works. "You can't have a sliding scale pipeline," he said.

REPRESENTATIVE KELLY replied, "Remember that we had the option to slide the scale."

MR. LOEFFLER responded, "The pipeline has to be designed to do something consistent. It can't be designed to do 4.5 one day and 3.8 in three years." "Who's making the FT commitment," he asked.

[11:43:00 AM](#)

SENATOR BEN STEVENS asked Representative Kelly whether he was talking about ownership of the pipe or bidding on FT commitment.

REPRESENTATIVE KELLY said, "Strictly the equity ownership of the pipe."

MR. LOEFFLER apologized and said he thought Representative Kelly was talking about ownership of the gas.

SENATOR BEN STEVENS said he wanted to clarify the initial question. He queried, "The initial question was if we do take off in state why would we want to have ownership of the pipe all the way to market?"

REPRESENTATIVE KELLY agreed. Assuming a mileage-sensitive rate and assuming Alaska ramped into full use of its share of the gas, why would the State want to own the pipe, he asked.

SENATOR BEN STEVENS stated that was easy since it would be a 14 percent return rate of return with no risk.

REPRESENTATIVE KELLY said it presents a case that addresses the fact that Alaska loses flexibility. If the State ramps into in state use then there will be capacity south of Fairbanks that will only be able to be filled through looping on the northern section.

MR. LOEFFLER said if the State wants options then it has to pay for it. The project needs the basic FT commitment in order to get built. If the State wants the option to take all of its gas for use in Alaska it will have to pay for that option.

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MR. CLARK said the logic of the deal is because of the way in which the State would take the gas, it would only be one more step to get to ownership. The reverse isn't true. The State will not be able to negotiate an arrangement whereby it could own the pipeline yet not take gas in kind. That would not be something the State would be able to negotiate and so the ticket to ownership in the pipeline is the willingness to take the gas in kind. The reality is given the fact that Alaska will have to ramp up state ownership over time, the timing of the open season is something the State will have to deal with. As a policy matter the State will have to get as many potential users ready as it possibly can.

BILL McMAHON, Commercial Manager, ExxonMobil Corporation, said as the open seasons occur and as in-state demand grows, the State will have the option of continuing to own 20 percent or it could sell down.

MR. MARKS added the important thing is alignment of the gas interest and the ownership interest. If down the line the two are mis-aligned then shifting of ownership could be done.

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CHAIR SEEKINS opined if any party decides it wants to sell down the options lie with the other LLC members. He called a recess for lunch.

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CHAIR SEEKINS called the meeting back to order and announced that United States Senator Lisa Murkowski would address the group shortly. After that the committee would continue the earlier meeting.

[1:31:45 PM](#)

UNITED STATES SENATOR LISA MURKOWSKI thanked the committee for holding the public meetings. The congressional delegation has worked very hard on the federal financial incentives toward the pipeline deal and hopes that this work will bring about a speedy agreement on the contract.

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US SENATOR MURKOWSKI thanked the committee for the opportunity to speak. She said this is the most important project that Alaska has in front of it today. The congressional delegation spent many hours working on the financial incentives and getting the permitting approved. The committee was successful in obtaining the federal loan guarantee and tax deductions for the North Slope conditioning plant, which will help tremendously toward saving pipeline sponsors considerable dollars. The expedited permitting and other aspects of federal incentives including Alaskan job training are very important federal incentives that are now in place. In 2005 the delegation encouraged FERC to issue its open season rulings, guaranteeing that Alaskans would have the right to take gas off the line for in-state use. The delegation encouraged the federal agencies to work out a memorandum of understanding that will unite the agencies and coordinate speeding the gas line along. Last week the White House formally nominated former Alaska State Senate President Drue Pearce to the position of pipeline coordinator for the project.

US SENATOR MURKOWSKI continued the project is important not only to Alaska but to the United States. Last week both the State Senate and House members received a letter from Vice President Dick Cheney speaking of the importance of the project. Time is of the essence to get the project underway, she stated. If the Alaska project is not approved quickly, energy companies might re-deploy their resources, which would result in significant delay of an Alaska project.

Residents of Alaska tend to think that there will always be a market for North Slope gas but that is not the case. Currently the United States receives 4 billion cubic feet of gas from LNG imports. Economists estimate that by the year 2010 LNG imports will reach 12 bcf a day and by the year 2030 imports will increase five fold.

US SENATOR MURKOWSKI advised the committee she met the chairman of the FERC on June 15 and they spoke about the import situation and about what is happening within the US to deal with increased demand. The Chairman indicated on that very day the FERC

approved expansion of two of the nation's five existing LNG receiving terminals and approved construction of three new terminals. These are primarily in the Louisiana area with one in New Jersey and one in Washington D.C. The five terminals are projected to increase capacity by 8.2 bcf a day. Essentially in one day's regulatory action the FERC brought on capacity by nearly twice what is expected of the Alaska Natural Gas Pipeline. On top of that the FERC has another 18 LNG project permits pending approval. The Chairman spoke about the Energy Policy Act of 2005 and advised within that Act provisions were inserted to speed up the permitting and approval process for many of the terminals.

There are 6,000 trillion cubic feet of stranded natural gas in the world, much of it with lift costs that are vastly lower than those in Alaska. One of them can produce natural gas for a nickel per thousand cubic feet. Alaska's 35 trillion cubic feet of known reserves seems insignificant compared to all the gas that is out there.

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US SENATOR MURKOWSKI continued FERC is required under the federal legislation to report every six months on what is happening with the gas line project. If the Alaska project is delayed even for a year it could drastically affect the chance to sell its gas. There are projects underway now to produce gas for the US market and so if Alaska is not aggressively involved in building the pipeline, it risks the gas remaining stranded for decades. "There is no time for Alaska to wait in advancing our natural gas project. If the project isn't approved quickly, Alaskans will be left out in the cold and shut out of the hundred billion dollars the State likely will receive from the current contract," she stated.

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SENATOR MURKOWSKI explained Alan Greenspan, former US Federal Reserve Chairman, believes it is more economic for the nation to buy LNG overseas than to build the pipeline. That viewpoint exists in Washington D.C. and people with great credibility are taking that perspective. If Alaska delays the project, it creates a chance for the other view to move forward. She urged legislators to renew their energy for moving the project forward.

Alaska expects to provide 9,000 total construction jobs just on the 730 miles of mainline pipe in the state. There are additional possibilities of construction of spur lines in South

Central. The gas is there and Alaska needs to proceed without delay because America needs Alaska's gas, she stated.

CHAIR SEEKINS asked US Senator Murkowski the precise expectation that Washington D.C. has of the Alaska Legislature.

US SENATOR MURKOWSKI replied the delegation worked hard in 2003 and 2004 to secure the federal incentives. "There is a general expectation among the members of Congress that Alaska's gas is on its way to the United States," she reported. There are approximately five senators each week that ask about the gas line. Whenever the topic of where America's energy is coming from arises, the chart is brought up that shows supply and demand of oil and another chart is brought up that shows supply and demand for natural gas. Alaska's gas shows as coming on line by 2014. The expectation is that Alaska will provide 4.5 bcf a day by then. Senator Murkowski said when she tells people that the contract is still in negotiation they are surprised. People want to know what the problem is with Alaska. If Alaska does not get its gas to market soon, it will not be competitive, she stated.

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CHAIR SEEKINS commented some Alaskans think that an over-the-top route is still being considered. He asked US Senator Murkowski to explain the attitude in Congress on that issue.

US SENATOR MURKOWSKI replied federal legislation clearly states there can be no over-the-top route and there can be no secret about it.

CHAIR SEEKINS asked whether the US Congress would allow a pipeline route to be built through the Alaska National Wildlife Reserve (ANWR).

US SENATOR MURKOWSKI said she was not willing to mix the gas line and ANWR issues right now. She said that might be one way to approach it though.

CHAIR SEEKINS asked her to comment on the possibility that the federal government would build the pipeline if Alaska didn't.

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US SENATOR MURKOWSKI stated the idea that the federal government is the best entity to build a pipeline is not realistic. The federal government serves best in an oversight capacity.

SENATOR OLSON asked whether Mr. Greenspan thought it was significantly cheaper to import gas than to build the pipeline. He asked whether Mr. Greenspan was actively trying to discourage the building of the pipeline.

US SENATOR MURKOWSKI responded Mr. Greenspan was speaking from the perspective that gas could be bought more cheaply on the open market and that diversification of a variety of sources was important so that the nation was not overly dependent on one area over another. She agrees that diversity of sources is imperative as Hurricane Katrina proved it is not smart to have all the nation's energy sources in one area. She pointed out the issue is not only about where to buy the cheapest gas; there is economic cost to energy vulnerability, which is where the US finds itself now. "Even if you do not like Hugo Chavez, you need Venezuela's oil," she stated.

CHAIR SEEKINS thanked US Senator Lisa Murkowski for speaking to the committee. He asked for comments from the producers on the topic of royalty in kind.

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MR. VAN TUYL said BP Alaska supports state participation in the pipeline. The model reduces overall risks in the project and eliminates the requirement for industry to pay capital up front and to take up FT obligations up front for gas that it doesn't directly own. The model is used and has been proven to work by other entities around the globe. It situates all of the parties in a commercially equivalent manner and creates alignment. That commercial alignment will allow participants to focus their collective energies on making the project succeed.

Another benefit for the State is that ownership provides a steady stream of tariff revenues for Alaska. The provisions in the contract mitigate the risks that Alaska would have by getting into the business of natural gas. The State would be embarking on the project with three very successful corporations and that also reduces risks for Alaska, he stated.

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MS. KING echoed the comments by Mr. Van Tuyl and added the contract is woven with the capacity commitment model. ConocoPhillips supports the model because it enhances the economics of the project and creates commercial alignments. For example, ConocoPhillips will take custody of its gas at the exact same spot that Alaska will. She said valuation methodologies have been argued in the past, but the State would

be able to make commercial decisions from an ownership position and retain the ability to either increase or decrease equity ownership over time.

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MR. McMAHON aired state ownership was the breakthrough to getting the agreement on the contract. Many times issues were traded while recognizing that certain things were of utmost importance to one party or another. State ownership solved many of the issues that came up during negotiations. Producers were looking for enhancements to make the low rate of return more attractive. The State was looking for a way to value gas for the payment of royalty and the production tax in a way that would reduce disputes. So when the State tabled the idea of gas in kind and tax gas it was able to address many of the concerns and allowed producers to drop the request of reduced state take. "Indeed state ownership, state capacity, state gas in kind does improve our economics," he stated. State ownership also solved the valuation problems the negotiations were facing since the State, rather than dispute the price, would be able to take and sell the gas itself. He expressed great support for the contract.

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JIM EASON, Legislative Consultant, stated it was a truism that if a person gives up his rights, he will never have to defend them again. "That seems to be the position that the Administration has taken regarding switching to in kind to avoid disputes over in value," he asserted. He said a fair amount of the discussion seems to be intended to cast a bad light on the in value taking since that has caused disputes in the past. Those disputes have arisen when the producers have not paid their obligations. In every case the disputes resulted ultimately in the producers having to pay a substantial amount of money to the State because they didn't pay correctly the first time. There has been much discussion on avoiding disputes and it's important to remember that disputes are not bad if they return hundreds of millions of dollars owed to the State.

MR. EASON continued a great deal of time has been spent talking about the core decision to move to in kind taking. Most of the benefits that have been cited are as benefits that come only from the in kind provision in the contract. "In fact the State has those benefits now," he said. But it also has other options of switching to in value. The State now controls whom it wants to sell oil to and also controls the price. In the contract, the State has agreed to give up a number of valuable provisions that

the State currently has in its leases and its unit agreements; some of which represent hundreds and hundreds of millions of dollars. It is not true that the in kind benefits that are being cited today arise only from being taken in kind under the circumstances that the producers are proposing under the contract, he stated.

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MR. EASON offered an example: If IRR is really a concern; the State could have approached it from a different way without absorbing or creating additional costs. Under the existing unit agreements, the State and the producers can negotiate the in kind taking point to be any point of their choosing. Historically it has been at the entrance to the oil pipeline for oil, but nothing says that has to happen. The State could have given the same IRR boost to the project by negotiating and agreeing to take its gas in kind at the Alberta Hub. In exchange the State would be fully responsible for the FT. This would present the same result but would drastically reduce additional costs to the State. These examples deserve more than just an hour of discussion, he asserted. The contract is made to sound like a very good deal, but it will result in significant implications to the State of Alaska.

DON SHEPLER, Legislative Consultant, observed the three producers at the table currently hold substantial firm capacity on existing pipelines in the Lower 48. A study done earlier in the year suggests it equates to 8.5 bcf a day on 25 pipelines. In those instances there is a different business model at work and so the question begs to be asked about the necessity of in kind taking and the holding of capacity when in the Lower 48 pipes the producers do not have the state upstream royalty owners and taxing authorities holding FT capacity.

PHILLIP GILDAN, Legislative Consultant, declined to comment.

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RICK HARPER, Legislative Consultant, pointed out he has not seen the LLC agreement, which is key to his personal assessment. He reiterated earlier comments that ownership in FT and ownership of the pipeline are two different issues. He said he differed with Mr. Marks on that subject. Normally an independent company does not take an FT commitment on it's own pipeline and so Mr. Shepler's comment about the different business model definitely applies. He said he remained very concerned about basin control and said he would like to reiterate his concerns at a later time and with a stronger point. Mr. Marks indicated the agreement

would give the State a seat at the table and operating and development decisions in the field, he noted. He offered that the State would be excluded from discussions revolving around development and exploration activities as well as other important discussions.

The hurdle rate was described earlier as a rate by which the producers recover their cost of capital and Mr. Harper stated a different opinion from that. A hurdle rate is simply an internal rate that is used as guidance within the company for projects within the company. In theory any project that clears the corporate hurdle rates will be done on executive committees of independent and major producers. Hurdle rates for exploration projects are normally much different than hurdle rates for development projects, particularly development projects where the assets are already substantially in place or depreciated in the field as in the case of Prudhoe Bay, he said.

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MR. HARPER referred to a point earlier that there can be no non-voluntary initiation of expansion until after commencement of pipeline operation. Certainly a voluntary expansion can occur or begin to occur prior to commencement of pipeline operations but contractually nothing can be forced prior to that time. He said he remained concerned about relying on FERC litigation strategies to solve problems related to expansion and basin control.

SENATOR BEN STEVENS asked Mr. Eason whom the State had the ability to sell its gas to right now.

MR. EASON replied the State has the right to take its gas and sell to anyone it wants. Under its existing lease and unit agreements, the State would have the option of selling its gas in kind at a pricing provision it determines and to persons it determines.

SENATOR BEN STEVENS retorted that was a hypothetical statement since the project was not completed.

MR. EASON responded that the entire conversation was hypothetical since the project was not built yet.

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SENATOR BEN STEVENS addressed Mr. Harper and said every presentation he has given has been critical of the contract. He asked Mr. Harper whether he had anything positive to say about

the contract and if so whether he could put it in writing and present it to the committee.

MR. HARPER said he has mentioned the hard work that has been done by Mr. Clark and Mr. Griffin and the others. He said he has been very complimentary about that.

SENATOR BEN STEVENS asked Mr. Harper whether he has been instructed to focus only on the negative aspect of the contract.

MR. HARPER stated he has not focused on the negative but has remained independent.

SENATOR BEN STEVENS asked to see documentation that Mr. Harper has presented something positive regarding the contract. "It seems that yours is the only presentation that never brings into any portion that this... it's only critical, Mr. Harper and I just wonder if maybe you're the hired pit bull on this project and whether you've had direction from the project manager to be that," he accused.

MR. HARPER replied he has been asked to be independent of the process. He has directed advice to Mr. Clark and his staff as well as the Legislature and has been very complimentary of the good work that has been done on the issue of capacity management.

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MS. KING said she would like to refute statements that the State has made all the concessions in the contract. "You've got to flip the page and look at the full balance of the deal," she said. She referred to Mr. Shepler's comment that the producers hold substantial FT commitments and said it is established practice to align ownership with basin-opening projects. To say there is a precedent in the Lower 48 is not true. With respect to upstream development, the State will take an ownership position in the pipeline and not the upstream development but there is a requirement in Article 10.7 that says the producer has to provide any information about the subject to the State.

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MR. VAN TUYL reiterated points made by Ms. King. He added there is a specific provision in AS 43.82.220(a) that says the contract could be modified at any time. The reference made by Mr. Shepler of 8 bcf a day in North America is like comparing apples to oranges. One can't compare a mature basin with the opening of a basin since there are unknown risks involved. The

whole notion of basin control is a dangerous term and is inflammatory and inappropriate, he asserted. "Clearly the gas pipeline industry in North America is very actively regulated," he said. The pipeline will be an open access pipeline and anyone that satisfies the requirements of the open season will have access to the pipe or access off of the pipe.

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MR. MARKS referred to the issue of Alaska's rights to take its gas in kind and said under current law the State cannot take taxes in kind. If the State were to take its gas in kind and not the give the FT commitment the project would clearly suffer that additional boost and might not even get built. Regarding the question of avoiding valuation disputes, he said, the State has not given up any money by going to the in kind system. On that point a concern was raised that by taking its gas at the lease boundary the State would incur additional upstream costs. This is not a concession, he said. There are agreements and the State will get the exact same amount of money that it would get under the status quo, he stated.

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The Lower 48 business model where producers have higher ownerships on the pipelines is not a business model that would convert to the Alaska situation. A project that carries gas from Houston to Dallas is quite different from a project that carries gas from Prudhoe Bay to Chicago. The Lower 48 project would have a higher rate of return and a lower hurdle rate.

Hurdle rates represent the cost in capital and what the company must repay to the investors, creditors and shareholders for the use of their money. It is commensurate with the risks of the project. Companies do not have a monolithic hurdle rate for projects, he said. A company building a hotel in Las Vegas and also building a hotel in Baghdad would have different hurdle rates for the projects.

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SENATOR ELTON asked Mr. Marks to define what he means when he talks about the "status quo." He asked whether he was referring to the present day without a pipeline or talking about status quo with a 20/20 gas line.

[2:38:52 PM](#)

MR. MARKS replied he was referring to current royalty provisions, current lease provisions and tax laws, and what the State would get if there were a gas pipeline today.

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SENATOR ELTON asked whether the status quo was just gas or gas and oil combined under existing statutes.

MR. MARKS replied absent a change to the oil taxes there is no difference to how much money the State would get for oil under the contract versus status quo. With the PPT in the mix, any but very low prices far exceed the status quo.

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SENATOR BEN STEVENS asked Mr. Shepler to provide the committee with the FERC Order 2005 as well as 2004.

MR. LOEFFLER advised the two Orders are 2005 and 2005A and said they reference the open season in Alaska. The statute is October 2004, he advised.

SENATOR BEN STEVENS asked for a synopsis of Order 636 from FERC.

MR. LOEFFLER asked Mr. Shepler whether his APCF was matched or unmatched with the amount of gas the companies have.

CHAIR SEEKINS asked for a definition of APCF.

MR. SHEPLER said it was a listing of the customer indexes and capacities that were shown on the FERC website sometime in early 2006. He does not have the data of whether the producers have lower capacity than production shift, he said.

MR. LOEFFLER said the 636 series required an unbundling of the pipeline function and the merchant function and non-discrimination requirements so that a company is not allowed to favor a subsidiary when offering capacity.

SENATOR BEN STEVENS clarified that an entity that owns a pipeline but also owns a production facility is required under FERC 636 to not favor its own company in the bid process.

MR. LOEFFLER added there is also a separation of functions so the pipeline company offers only a transportation service and not the bundled product of transportation and gas.

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SENATOR BEN STEVENS asked whether FERC Order 636 regulated that.

MR. LOEFFLER said it was established under the Natural Gas Development Act implemented in Order 636 and is enforced by FERC.

SENATOR BEN STEVENS said if there is a continual concern over basin control, then he wanted documentation that Congressional laws exists to address it.

[2:48:03 PM](#)

MR. CLARK interjected one could not have a fair reading of the SGDA as amended in 2003 other than to instruct the Executive Branch to attempt to negotiate a business arrangement. The SGDA does not advise anyone to litigate and take gas away from the producers. The negotiation of the contract is along the instruction of the SGDA and that was the intent of the Act, he said.

[2:50:25 PM](#)

MR. GRIFFIN referred to Mr. Eason's comments that the State's arguments prevailed in each litigated case and said it was true that the disputes were worthwhile but the State would argue that they received no more than what they deserved. The in kind system would ensure that the State gets its share of the gas with very low prospect of litigation and the value will be very near to the status quo. He referred to Mr. Eason's comments about giving up the lease provisions and said there are concessions from both sides in the contract. He said he enumerated these in the fiscal findings and urged committee members to look at all the payments in terms of the bottom line.

[2:52:33 PM](#)

MR. GRIFFIN referred to Mr. Harper's comment on the hurdle rate and said normally it is the case that they are higher for an exploratory project and the reason is because the failure rate is much larger. The largest risk is the reserves risk but in the Alaska project the reserves risk is minimal although there are many other risks, such as fiscal risk and price risk. Because of that set of risks this project should be looked at more similar to an exploratory project than a developmental opportunity, he stated.

CHAIR SEEKINS announced the committee would take a brief recess at [2:54:03 PM](#).

[3:05:49 PM](#)

CHAIR SEEKINS called the meeting back to order and announced the topics would be Alaska hire and Alaska purchase.

GREG O'CLARAY, Commissioner, Department of Labor and Workforce Development (DOLWD), advised the committee that provisions in Article 6 of the contract would ensure that Alaska workers and Alaska businesses will be fully utilized and the State would see the added benefits of those dollars staying in Alaska. With respect to federal constitutional constraints, the Alaska hire provision could not be so strong as to be challenged in court as unconstitutional. The touchstone of success in terms of use of Alaska workers has to do with the preparation and training and availability of Alaska workers and businesses to perform when the project comes on line.

The department tends to concentrate on the 9,000 jobs in direct construction and the work would begin in 90 days of contract approval but there is so much work involved in the pre-design that perhaps the State has missed the total picture in terms of economic benefit to Alaska. The investment goes beyond just the construction; it includes the operation. If the State had the same commitment in TAPS there would be more Alaskans working on the North Slope today than there are. His vision is to have over 90 percent of Alaskans working in every category of the industry and that is a tremendous opportunity for the young people of the state. He advised the committee that he is committed to making Alaska hire a great success.

CHAIR SEEKINS said he lived through the construction of the Trans Alaska Pipeline where recruiters strongly urged Alaska workers to leave their jobs and join the pipeline. It created a huge disruption in the workplace and when the construction was done these people were left unemployed and unable to return to their old jobs. He asked whether the Alaska hire provisions would create the same problems all over again.

COMMISSIONER O'CLARAY advised he has adopted an economy-wide approach and cautioned members not to think of just the construction part of the project. When the DOLWD goes into the schools they talk about more than just construction jobs. "The State cannot afford to be so myopic in its view that they're only going to train pipeline workers," he stated. The millions of dollars that flow through the department must support all of the jobs in Alaska. Employers who want to keep their workers figure out benefit structures that do exactly that, such as pensions and profit sharing.

[3:15:49 PM](#)

SENATOR ELTON asked Commissioner O'Claray to comment on language in Article 6.2(b) in the contract that speaks about "qualified Alaskans."

COMMISSIONER O'CLARAY deferred the question to Mr. Loeffler.

MR. LOEFFLER pointed out the language in Article 6.2(b) comes from the SGDA. He said the language was not intended to import \$2.50 an hour workers to the detriment of Alaska workers. The Administration hopes to amend the SGDA and the contract with language that will correct that interpretation.

MR. CLARK noted one of the benefits of the roundtable discussion was to bring up constructive points such as the one Senator Elton brought up. He asked for input to help correct the matter.

CHAIR SEEKINS recognized Mr. Sampson and Mr. Lithy.

[3:18:50 PM](#)

JIM LITHY, Business Manager, Plumbers and Pipefitters Local 375, expressed concern over a lack of provision in the contract that would ensure Alaska workers would have the opportunity to work on the project. There does not appear to be substantial assurance in the contract. In order to maximize the opportunity for Alaska craft workers there must be some assurance of access for the jobs other than just entry-level positions. He suggested the committee consider using a project labor agreement.

[3:20:35 PM](#)

JIM SAMPSON, President, Alaska AFL-CIO, suggested the State must insist on a project labor agreement. A project labor agreement would provide predictable labor costs, establish uniform wages and benefits, guarantee labor peace and secure a stable supply of skilled Alaska workers through the duration of the project. A labor agreement would also provide a legally defensive way of ensuring Alaska hire. Efforts to successfully prepare the workforce should be made early on.

[3:24:21 PM](#)

Currently the contract has language in it that is harmful to Alaskan workers and Alaska businesses, he asserted. He urged committee members to reach out to the contract industry for language input. The State and its sponsors need to understand the labor costs and be able to secure qualified workers. Alaska must have appropriate labor protections for its workers and this will happen by working together. Current language in the contract drives down wage protections that Alaska families rely

on. The union has questions regarding wage protection since the State is considering entering into ownership. Not only will the State become a market participant but will also remain a regulator. He questioned whether Davis-Bacon rates would apply to the project. He encouraged legislators to include legislation for needed training funding to help the effort.

[3:27:08 PM](#)

MR. SAMPSON referred to the "TAPS experience" and said the workforce was different now. A number of Alaska contractors were used in the project but perhaps not enough were used appropriately. He listed many of the projects associated with the project. He advised the committee to dispense with the language in Article 6.2(b) and proposed using language from the National Labor Relations Act along with a project labor agreement since that has held up in court.

[3:33:14 PM](#)

MR. SAMPSON summarized the SGDA should be amended to include language on labor agreements. Labor costs should go into the findings and into the contract but not necessarily into Article 6.2.

[3:36:54 PM](#)

MR. CLARK responded Mr. Sampson's suggestions have not occurred to the Administration. The issue is in the sequence of events and so the absence of a project labor agreement in the contract does not mean that they are proceeding without a project labor agreement, he stated. The Administration is currently putting together the fiscal contract so as to set the fiscal terms for the State's involvement with the producers. Once that happens the parties will move on to the next phase. Within 90 days after signature the permitting and design engineering happens and that is the step where involvement would occur and labor negotiations would begin.

[3:42:04 PM](#)

CHAIR SEEKINS cited language from Section 230(a) of the SGDA and said the commissioner shall also include in the contract under AS 43.82.020 a term that requires the qualified sponsor or qualified sponsor group and contractors of the qualified sponsor or qualified sponsor group to employ Alaska residents and to contract with Alaska businesses to work in the state on the approved qualified project to the extent the residents and businesses are available, competitively priced and qualified.

COMMISSIONER O'CLARAY replied that was correct and that there was expansion of the language that follows in the contract. He said it was important to emphasize that labor must play a role in the project.

[3:44:43 PM](#)

CHAIR SEEKINS said he had difficulty with the definition of "competitively priced."

MR. SAMPSON commented the union has a solid understanding of what it takes to get workers adequately trained. They spend millions of dollars each year on apprenticeship programs and have been training construction workers for 50 years. Alaska contractors privately fund all of the programs. The record should be clear on the union's commitment to training but to suggest that \$5 million dollars on a \$25 billion dollar project is sufficient is unreal, he stated.

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MR. CLARK interrupted to say that \$5 million dollars is well spent according to language in the contract. It will look to internal training and that is an important distinction because internal training will ensure top to bottom organization. The Administration has no intention of dropping Article 6.2(b) but they are committed to improving the language for better protection.

[3:48:33 PM](#)

CHAIR SEEKINS said he could not find a definition for "competitively priced" but there is a difference between construction worker's wages in Alaska and the Lower 48.

MR. SAMPSON agreed and said Alaska wages were slightly lower but competitively priced. The project agreement for TAPS was too high because once the project was finished the state was flooded with unemployed workers with a wage package that was too high to compete with. Lawyers wrote Article 6.2 and it reads to say that contractors can come up to Alaska and bring their crews with them, he cautioned. In contrast, Alaska contractors usually hire Alaska people.

[3:53:57 PM](#)

MR. CLARK interjected the reality is that the terms and wages would be negotiated in the labor agreement.

MR. SAMPSON responded labor would like to know what the Administration's position is as it relates to the applicability

to Title 36 of the project. He questioned whether the State, as equity owner, was subject to Title 36.

MR. CLARK said that issue becomes moot in the project labor agreement.

CHAIR SEEKINS suggested the committee get a preliminary opinion regarding the equity ownership issue and Davis-Bacon wages on the project. He asked Mr. Clark to gather some information on the subject.

3:56:27 PM

MR. CLARK agreed and noted there should be more discussion on the subject. He invited Mr. Sampson to the Governor's mansion to talk about his concerns.

REPRESENTATIVE KELLY commented everyone comes to the table with "a list that they want taken care of." He advised the committee to be careful not to promise too much just because it was an election year. The project's largest risk is cost over runs and negotiating too high of wages could compromise the entire deal. Project labor agreements have a place but if the end deal has imposed work rules that make no sense, such as paying somebody 4 hours minimum to "come out and plug in a Honda" it will be a big mistake. The natural tension between labor and business must remain, he said.

MR. CLARK advised the economic terms with labor would be another step in the project. The State ownership in the pipeline would be beneficial to all the citizens of Alaska. Cost over runs and low gas prices are the two things that could hurt the most, which is why things have to be ironed out sequentially.

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MR. CLARK continued the reason the labor agreement is not in the contract is because it must be worked out in a sequential, organized, systematic fashion. Governor Murkowski feels that the next step in the sequence will not occur until after the signing of the fiscal contract.

CHAIR SEEKINS countered Section 230(a) in the SGDA states the State must include the terms within the constraint of law.

MR. CLARK said the Administration is still dealing with economic commitments that must be made in order to "figure out the fiscal terms." The actual cost of labor is the next step and must be calculated with the actual design of the project. A project

labor agreement is not easily added and there might be more than one labor agreement. There are many specific issues associated with putting together a project labor agreement and "it's a big deal," he said.

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SENATOR ELTON said he sees the fiscal contract as providing certainty toward getting the pipeline built. One of the things that should be nailed down in the fiscal contract is a well-trained workforce rather worrying about a sequential progress toward a decision on whether or not there will be a project labor agreement. He said the sequencing approach is bothersome and does not seem to bring people together. Article 6.2 doesn't have a thing to do with training, he added.

CHAIR SEEKINS invited Mr. Sampson and Mr. Lithy to attend the special session so that the issue could be further addressed.

[4:10:05 PM](#)

MR. VAN TUYL responded to Senator Elton and said he was correct in that Article 6.2 does not contain language that details the obligations that the midstream entity would have to provide the training. It references the money and the programs as well as complications with the DOLWD. Article 6.4 contains the training language. Regarding the project labor agreement, the contract itself defines the relationship between the State of Alaska and the producers, he said. The labor agreement would be a matter between whoever is executing the project and labor. The project, given its scope and scale, is projected to tax the entire North American labor market, he asserted.

[4:15:16 PM](#)

MS. KING advised the committee that AS 43.82.030 was clearly the landscape given to the producers when discussing the Alaska hire provision. She spoke with several committees on the topic and remembered the intent language tabled by Representative Harris at the time. She emphasized that ConocoPhillips is committed to Alaska hire buy and build. However, they remain concerned that there will be a huge demand for labor on the project. One of the key provisions in the contract is work on the planning phase. The landscape in things such as labor and steel has changed since the 2002 study. That is the reason they stipulated that they would not come to the table with labor until after the project planning phase.

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CHAIR SEEKINS asked Ms. King whether cost estimates in the study included labor costs of prevailing Alaska wages.

MS. KING said she did not know.

SENATOR ELTON aired as the costs of materials and labor and permits are reviewed adjustments are made through the qualified project plan. He stated his concern was the forum in which the producers are running the qualified project plan. That plan can be changed over the objections of the State and so the State might not have the leverage needed to ensure the producers are hiring Alaska workers.

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MS. KING responded that was an advantage the producers saw with state ownership. The qualified project plan requires that the mainline entity is the party that provides the public document. The LLC will be formed to own that and the State will be a 20 percent owner.

MR. VAN TUYL said, "Ditto." The midstream entity is the one that has the obligation under the contract to generate the qualified project plan. The State will be a 20 percent owner in the entity and will absolutely have a voice. Regarding the entire topic of Alaska hire, BP is committed to the concept and stands by its record on the matter.

[4:22:30 PM](#)

CHAIR SEEKINS asked Mr. Clark to address the fiscal certainty issue in synopsis.

MR. CLARK deferred to Mr. Dickinson.

MR. DICKINSON offered a rough approximation of the fiscal certainly on oil. He focused on the period between 1973-1981 and called it the period when the State's fiscal system transited from focusing on Cook Inlet to the North Slope oil industry. In that period the State started out by passing an oil and gas property tax - a special statewide tax on oil and gas property. They went to the production tax in 1977 and raised the marginal rate from 8 percent to 12.25 percent. Four years later it went up to 15 percent. In 1978 the State switched the income tax to separate accounting and then in 1981 switched back to modified apportionment. This affected how people thought about the fiscal system. There was a fundamental shift in both the mechanism of how taxes were collected from the oil industry as well as what

the State based their entire fiscal system on. That is important when talking about the next thirty years.

A thirty-year fiscal stability period makes sense because it covers the two initial phases of the project. That is the period in which the project will get built and where the initial financial terms will be ironed out and met. Arguably, stability is imperative for that phase. Fiscal stability is where the money is, he stated. Nobody wants to do "back door renegotiations." The three entities are the three largest taxpayers in the State and they cover approximately 65 percent of the general fund budget. Fundamentally the first thirty years will be a period where oil is still a significant but declining portion of state's revenues.

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MR. DICKINSON continued "compounding interest" was cited by Albert Einstein as one of the most powerful forces in the universe. There are a number of PILTS, which are driven by inflation. These PILTS have replaced the property and right now there is depreciation and inflation in the cost of new construction. The volumes being produced and inflation are the two things that drive the PILTS. He said:

Quite frankly, if you look at what happens to inflation over 15 or 30 years, we were following the commandments of the SGDA, we were back end loading certain aspects of the fiscal regime and quite frankly the tensions there run the other way. The folks that will be recipients of the PILTS should [want] those to be for the longest period of time possible. In fact one of the problems that we acknowledged for some of the assets is that at the end of that 30 years, there could well be a cliff because when folks come in again and ask the percent utilization, those assets may fall dramatically in value at the end of this contract.

MR. DICKINSON urged the committee to look at what generally happens over time and to consider inflation when doing so. A small dispute when not resolved can turn into huge amounts of money when the issue finally comes to resolution. With State ownership conflicts will certainly be less and this will contribute to fiscal stability in relation to the project.

[4:32:03 PM](#)

MR. DICKINSON advised the committee that he would speak on how an amendment to the SGDA puts conditions on oil fiscal certainty.

He said the current contract would not meet the conditions and since the Administration believes that the current contract works, that presents a problem. The Administration is committed to looking at the terms and figuring out how to incorporate them into the contract. In relation to production tax, the Senate Bill provides no fiscal stability on oil. Things remain status quo and conflicts would go to court. People are concerned that there will be a revision of the production tax and mistakes might have been made with no period in which to fix the mistakes.

[4:35:09 PM](#)

In the middle period of the contract the amendment would cause a switch to a different type of concept of fiscal stability. The reason the contract is so long is due to all the situations that might arise that must be addressed and procedures must be laid out to deal with them. Right now the contract offers a period of fiscal stability for the three major taxes but the Senate Bill takes one of the taxes and breaks it into three pieces and proposes two different concepts of fiscal stability; one for the critical period of construction and one for the remainder period. The State needs 30 years of fiscal stability, he said. The arbitration factor could cause much litigation and renegotiation of the contract.

[4:39:38 PM](#)

REPRESENTATIVE KELLY asked Mr. Dickinson whether the State would be able to change the tax structure if the economics change in the future.

MR. DICKINSON said he had no idea. Senator Stevens introduced the bill and it does not say. It would all depend on the language in the contract, interpretation of the SGDA, and the situations taken into account.

CHAIR SEEKINS advised the committee of the agenda for the following meeting. He thanked the members, producers, consultants and the general public for their attendance. He adjourned the meeting at [4:45:32 PM](#).